ADOBE SYSTEMS INC
Form 10-Q
September 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 August 29, 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 September 19, 2014 was 498,738,874.

ADOBE SYSTEMS INCORPORATED
FORM 10-Q

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PART I—FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	August 29, 2014 (Unaudited)	November 29, 2013 (*)
ASSETS		
Current assets:		
Cash and cash equivalents	$903,329	$834,556
Short-term investments	2,616,868	2,339,196
Trade receivables, net of allowances for doubtful accounts of $7,879 and $10,228, respectively	528,331	599,820
Deferred income taxes	79,713	102,247
Prepaid expenses and other current assets	151,227	170,110
Total current assets	4,279,468	4,045,929
Property and equipment, net	785,856	659,774
Goodwill	4,746,781	4,771,981
Purchased and other intangibles, net	490,839	605,254
Investment in lease receivable	80,439	207,239
Other assets	110,297	90,121
Total assets	$10,493,680	$10,380,298
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	$53,791	$62,096
Accrued expenses	630,679	656,939
Debt and capital lease obligations	606,426	14,676
Accrued restructuring	2,351	6,171
Income taxes payable	4,438	10,222
Deferred revenue	947,563	775,544
Total current liabilities	2,245,248	1,525,648
Long-term liabilities:		
Debt and capital lease obligations	901,830	1,499,297
Deferred revenue	48,975	53,268
Accrued restructuring	5,776	7,717
Income taxes payable	141,473	132,545
Deferred income taxes	344,715	375,634
Other liabilities	74,403	61,555
Total liabilities	3,762,420	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; 498,599 and 496,261 shares outstanding, respectively	61	61
Additional paid-in-capital	3,675,629	3,392,696

Retained earnings	6,850,790	6,928,964
Accumulated other comprehensive income	20,067	46,103
Treasury stock, at cost (102,235 and 104,573 shares, respectively), net of reissuances	(3,815,287)	(3,643,190)
Total stockholders’ equity	6,731,260	6,724,634
Total liabilities and stockholders’ equity	$10,493,680	$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		Nine Months Ended	
	August 29, 2014	August 30, 2013	August 29, 2014	August 30, 2013
Revenue:				
Products	$349,151	$582,178	$1,299,852	$1,902,866
Subscription	547,373	299,346	1,447,630	778,133
Services and support	108,885	113,595	326,255	332,542
Total revenue	1,005,409	995,119	3,073,737	3,013,541
Cost of revenue:				
Products	23,172	32,564	75,169	111,351
Subscription	86,670	71,656	247,549	200,763
Services and support	47,882	42,856	138,419	126,927
Total cost of revenue	157,724	147,076	461,137	439,041
Gross profit	847,685	848,043	2,612,600	2,574,500
Operating expenses:				
Research and development	212,049	208,700	630,666	621,435
Sales and marketing	406,475	388,673	1,243,446	1,188,914
General and administrative	141,676	128,043	409,798	381,766
Restructuring and other charges	201	(791)	498	24,203
Amortization of purchased intangibles	13,108	13,064	40,012	38,295
Total operating expenses	773,509	737,689	2,324,420	2,254,613
Operating income	74,176	110,354	288,180	319,887
Non-operating income (expense):				
Interest and other income (expense), net	1,454	1,732	7,162	4,246
Interest expense	(13,361)	(16,747)	(47,054)	(50,786)
Investment gains (losses), net	669	(2,079)	813	(5,476)
Total non-operating income (expense), net	(11,238)	(17,094)	(39,079)	(52,016)
Income before income taxes	62,938	93,260	249,101	267,871
Provision for income taxes	18,252	10,258	68,842	43,206
Net income	$44,686	$83,002	$180,259	$224,665
Basic net income per share	$0.09	$0.16	$0.36	$0.45
Shares used to compute basic net income per share	498,468	504,116	497,782	502,039
Diluted net income per share	$0.09	$0.16	$0.35	$0.44
Shares used to compute diluted net income per share	507,811	514,058	508,575	513,155

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended		Nine Months Ended	
	August 29, 2014	August 30, 2013	August 29, 2014	August 30, 2013
	Increase/(Decrease)		Increase/(Decrease)	
Net income	$44,686	$83,002	$180,259	$224,665
Other comprehensive income, net of taxes:				
Available-for-sale securities:				
Unrealized gains / losses on available-for-sale securities	(1,822)	(7,757)	1,666	(12,310)
Reclassification adjustment for gains / losses on available-for-sale securities recognized	(1,592)	46	(3,480)	(2,326)
Net increase (decrease) from available-for-sale securities	(3,414)	(7,711)	(1,814)	(14,636)
Derivatives designated as hedging instruments:				
Unrealized gains / losses on derivative instruments	10,003	(2,947)	11,976	29,713
Reclassification adjustment for gains / losses on derivative instruments recognized	(1,075)	(10,487)	(6,490)	(32,880)
Net increase (decrease) from derivatives designated as hedging instruments	8,928	(13,434)	5,486	(3,167)
Foreign currency translation adjustments	(32,090)	6,651	(29,708)	57
Other comprehensive income, net of taxes	(26,576)	(14,494)	(26,036)	(17,746)
Total comprehensive income, net of taxes	$18,110	$68,508	$154,223	$206,919

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Nine Months Ended	
	August 29, 2014	August 30, 2013
Cash flows from operating activities:		
Net income	$180,259	$224,665
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	235,443	239,877
Stock-based compensation	248,811	244,090
Deferred income taxes	(7,912)	41,002
Write down of assets held for sale	—	23,838
Unrealized (gains) losses on investments	47	6,719
Tax benefit (shortfall) from employee stock option plans	31,883	(17,186)
Other non-cash items	829	2,972
Excess tax benefits from stock-based compensation	(31,953)	—
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Trade receivables, net	71,973	112,015
Prepaid expenses and other current assets	13,352	(13,669)
Trade payables	(8,305)	16,106
Accrued expenses	(13,749)	(65,992)
Accrued restructuring	(5,627)	(8,454)
Income taxes payable	4,952	(75,908)
Deferred revenue	167,726	106,629
Net cash provided by operating activities	887,729	836,704
Cash flows from investing activities:		
Purchases of short-term investments	(1,412,539)	(1,635,999)
Maturities of short-term investments	913,308	292,374
Proceeds from sales of short-term investments	209,172	1,084,873
Acquisitions, net of cash acquired	—	(704,375)
Purchases of property and equipment	(111,557)	(153,237)
Purchases of long-term investments and other assets	(12,496)	(64,820)
Proceeds from sale of long-term investments	1,364	3,396
Net cash used for investing activities	(412,748)	(1,177,788)
Cash flows from financing activities:		
Purchases of treasury stock	(475,000)	(700,000)
Proceeds from issuance of treasury stock	213,841	526,240
Cost of issuance of treasury stock	(163,293)	(90,356)
Excess tax benefits from stock-based compensation	31,953	—
Proceeds from debt and capital lease obligations	—	25,703
Repayment of debt and capital lease obligations	(11,431)	(19,838)
Debt issuance costs	—	(357)
Net cash used for financing activities	(403,930)	(258,608)
Effect of foreign currency exchange rates on cash and cash equivalents	(2,278)	(6,275)
Net decrease in cash and cash equivalents	68,773	(605,967)
Cash and cash equivalents at beginning of period	834,556	1,425,052

Cash and cash equivalents at end of period	$903,329	$819,085
Supplemental disclosures:		
Cash paid for income taxes, net of refunds	$7,114	$110,697
Cash paid for interest	$61,562	$64,334
Non-cash investing activities:		
Investment in lease receivable applied to building purchase	$126,800	$—
Issuance of common stock and stock awards assumed in business acquisitions	$—	$1,160

See accompanying Notes to Condensed Consolidated Financial Statements.

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

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

We have prepared the accompanying unaudited Condensed Consolidated Financial Statements pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Pursuant to these rules and regulations, we have condensed or omitted certain information and footnote disclosures we normally include in our annual Consolidated Financial Statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In management’s opinion, we have made all adjustments (consisting only of normal, recurring adjustments, except as otherwise indicated) necessary to fairly present our financial position, results of operations and cash flows. Our interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. These financial statements and accompanying notes should be read in conjunction with the Consolidated Financial Statements and notes thereto in our Annual Report on Form 10-K for the fiscal year ended November 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 nine months ended August 29, 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 August 29, 2014 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$274,463	$—	$—	$274,463
Cash equivalents:				
Money market mutual funds	565,996	—	—	565,996
Time deposits	62,870	—	—	62,870
Total cash equivalents	628,866	—	—	628,866
Total cash and cash equivalents	903,329	—	—	903,329
Short-term fixed income securities:				
Corporate bonds and commercial paper	1,456,706	5,955	(425)	1,462,236
Foreign government securities	23,128	40	(3)	23,165
Municipal securities	185,634	543	(5)	186,172
U.S. agency securities	506,227	881	(260)	506,848
U.S. Treasury securities	437,362	580	(122)	437,820
Subtotal	2,609,057	7,999	(815)	2,616,241
Marketable equity securities	174	453	—	627
Total short-term investments	2,609,231	8,452	(815)	2,616,868
Total cash, cash equivalents and short-term investments	$3,512,560	$8,452	$(815)	$3,520,197

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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 August 29, 2014 and November 29, 2013 (in thousands):

	2014		2013	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$256,849	$(289)	$225,759	$(631)
Foreign government securities	7,595	(3)	—	—
Municipal securities	9,837	(5)	13,522	(24)
U.S. Treasury and agency securities	169,621	(232)	105,278	(283)
Total	$443,902	$(529)	$344,559	$(938)

There were 208 securities and 177 securities in an unrealized loss position for less than twelve months at August 29, 2014 and at November 29, 2013, respectively.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category, that were in a continuous unrealized loss position for more than twelve months, as of August 29, 2014 (in thousands):

	2014	
	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$18,577	$(136)
U.S. Treasury and agency securities	29,416	(150)
Total	$47,993	$(286)

As of August 29, 2014, there were 16 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 August 29, 2014 (in thousands):

	Amortized Cost	Estimated Fair Value
Due within one year	$629,477	$630,712
Due between one and two years	808,082	810,830
Due between two and three years	915,643	918,119
Due after three years	255,855	256,580
Total	$2,609,057	$2,616,241

We review our debt and marketable equity securities classified as short-term investments on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. We consider factors such as the length of time and extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer and our intent to sell, or whether it is more likely than not we will be required to sell the investment before recovery of the investment’s amortized cost basis. If we believe that an other-than-temporary decline exists in one of these securities, we write down these investments to fair value. For debt securities, the portion of the write-down related to credit loss would be recorded to interest and other income, net in our Condensed Consolidated Statements of Income. Any portion not related to credit loss would be recorded to accumulated other comprehensive income, which is reflected as a separate component of stockholders’ equity in our Condensed Consolidated Balance Sheets. For equity securities, the write-down would be recorded to investment gains (losses), net in our Condensed Consolidated Statements of Income. During the nine months ended August 29, 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 nine months ended August 29, 2014.
The fair value of our financial assets and liabilities at August 29, 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	$565,996	$565,996	$—	$—
Time deposits	62,870	62,870	—	—
Short-term investments:				
Corporate bonds and commercial paper	1,462,236	—	1,462,236	—
Foreign government securities	23,165	—	23,165	—
Marketable equity securities	627	627	—	—
Municipal securities	186,172	—	186,172	—
U.S. agency securities	506,848	—	506,848	—
U.S. Treasury securities	437,820	—	437,820	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	14,384	—	14,384	—
Other assets:				
Deferred compensation plan assets	24,821	536	24,285	—
Interest rate swap derivatives	5,146	—	5,146	—
Total assets	$3,290,085	$630,029	$2,660,056	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$969	$—	$969	$—
Total liabilities	$969	$—	$969	$—

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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 and derivatives having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques. Our procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources.
Our deferred compensation plan assets consist of prime money market funds and mutual funds.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We also have direct investments in privately held companies accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. If we determine that an other-than-temporary impairment has occurred, we write down the investment to its fair value. We estimate fair value of our cost method investments considering available information such as pricing in recent rounds of financing, current cash positions, earnings and cash flow forecasts, recent operational performance and any other readily available market data. For the three and nine months ended August 29, 2014, we determined there were no other-than-temporary impairments on our cost method investments. Comparatively, for the three and nine months ended August 30, 2013, we determined there were other-than-temporary impairments of $2.0 million and $7.0 million, respectively, on our cost method investments which were written down to fair value.

As of August 29, 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 senior notes was $1.6 billion as of August 29, 2014, based on observable market prices in less active market and categorized as Level 2. 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.

Fair Value Hedging—Interest Rate Swap

During the third quarter of fiscal 2014, we entered into interest rate swaps designated as a fair value hedge related to our $900.0 million of 4.75% fixed interest rate senior notes due February 1, 2020 (the “2020 Notes”). In effect, the interest rate swaps convert the fixed interest rate on our 2020 Notes to a floating interest rate based on the London Interbank Offered Rate (“LIBOR”). Under the terms of the swaps, we will pay monthly interest at the one-month LIBOR rate plus a fixed number of basis points on the $900 million notional amount through February 1, 2020. In exchange, we will receive 4.75% fixed rate interest from the swap counterparties. See Note 13 for further details regarding our debt.

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

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

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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.

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 August 29, 2014 and November 29, 2013 were as follows (in thousands):

	2014		2013	
	Fair Value Asset Derivatives	Fair Value Liability Derivatives	Fair Value Asset Derivatives	Fair Value Liability Derivatives
Derivatives designated as hedging instruments:				
Foreign exchange option contracts[(1) (3)]	$13,153	$—	$8,913	$—
Interest rate swap [(2)]	5,146	—	—	—
Derivatives not designated as hedging instruments:				
Foreign exchange forward contracts [(1)]	1,231	969	2,978	1,067
Total derivatives	$19,530	$969	$11,891	$1,067

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

(2) Included in other assets 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.

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

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

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 nine months ended August 30, 2013 was as follows (in thousands):

	Three Months		Nine Months	
	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts
Derivatives in cash flow hedging relationships:				
Net gain (loss) recognized in OCI, net of tax[1]	$(2,947)	$—	$29,713	$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax[2]	$10,487	$—	$32,880	$—
Net gain (loss) recognized in income[3]	$(3,989)	$—	$(13,656)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income[4]	$—	$(2,028)	$—	$2,768

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(1) Net change in the fair value of the effective portion classified in other comprehensive income (“OCI”).

(2) Effective portion classified as revenue.

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 6. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Goodwill as of August 29, 2014 and November 29, 2013 was $4.747 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 August 29, 2014 and November 29, 2013 were as follows (in thousands):

	2014			2013		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Purchased technology	$400,114	$ (254,595)	$145,519	$423,237	$ (220,414)	$202,823
Customer contracts and relationships	$380,753	$ (134,892)	$245,861	$389,800	$ (111,416)	$278,384
Trademarks	67,105	(34,496)	32,609	67,546	(27,933)	39,613
Acquired rights to use technology	157,827	(92,948)	64,879	155,322	(76,740)	78,582
Localization	1,442	(956)	486	3,404	(2,172)	1,232
Other intangibles	12,473	(10,988)	1,485	16,447	(11,827)	4,620
Total other intangible assets	$619,600	$ (274,280)	$345,320	$632,519	$ (230,088)	$402,431
Purchased and other intangible assets, net	$1,019,714	$ (528,875)	$490,839	$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. Amortization expense related to purchased and other intangible assets was $39.1 million and $115.1 million for the three and nine months ended August 29, 2014, 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 $42.2 million and $117.1 million for the three and nine months ended August 30, 2013, respectively. Of these amounts, $26.0 million and $75.1 million were included in cost of sales for the three and nine months ended August 29, 2014, respectively, and $29.4 million and $79.6 million for the three and nine months ended August 30, 2013, respectively.

As of August 29, 2014, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2014	$18,692	$ 18,196
2015	61,000	68,267
2016	22,646	62,298
2017	15,197	52,916
2018	8,803	42,021

Thereafter	19,181	101,622
Total expected amortization expense	$ 145,519	$ 345,320

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(Unaudited)

NOTE 7. ACCRUED EXPENSES

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

	2014	2013
Accrued compensation and benefits	$309,507	$318,219
Sales and marketing allowances	73,792	66,502
Accrued corporate marketing	27,522	22,801
Taxes payable	17,241	18,225
Royalties payable	12,300	14,778
Accrued interest expense	7,295	20,613
Other	183,022	195,801
Accrued expenses	$630,679	$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 August 29, 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.

NOTE 8. STOCK-BASED COMPENSATION

Summary of Restricted Stock Units

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

	2014	2013
Beginning outstanding balance	17,948	18,415
Awarded	4,054	7,236
Released	(7,085)	(6,224)
Forfeited	(1,072)	(1,479)
Ending outstanding balance	13,845	17,948

Information regarding restricted stock units outstanding at August 29, 2014 and August 30, 2013 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2014			
Restricted stock units outstanding	13,845	1.12	$995.5
Restricted stock units vested and expected to vest	12,367	1.05	$882.4
2013			
Restricted stock units outstanding	18,163	1.29	$831
Restricted stock units vested and expected to vest	16,159	1.22	$736.8

(*) 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 August 29, 2014 and August 30, 2013 were $71.90 and $45.75, respectively.

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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.

As of August 29, 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 nine months ended August 29, 2014 (in thousands):

	Shares Granted	Maximum Shares Eligible to Receive
Beginning outstanding balance	854	1,707
Awarded	709	1,417
Forfeited	(46)	(90)
Ending outstanding balance	1,517	3,034

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 nine months ended August 29, 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	(21)	(141)
Ending outstanding balance	354	861

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(Unaudited)

Information regarding performance shares outstanding at August 29, 2014 and August 30, 2013 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value[*] (millions)
2014			
Performance shares outstanding	354	0.41	$25.4
Performance shares vested and expected to vest	339	0.41	$24.2
2013			
Performance shares outstanding	868	0.83	$39.7
Performance shares vested and expected to vest	804	0.81	$36.7

(*) The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ Global Select Market, the market values as of August 29, 2014 and August 30, 2013 were $71.90 and $45.75, respectively.

Summary of Stock Options

There were no option grants during the three and nine months ended August 29, 2014 and the three months ended August 30, 2013. The assumptions used to value the option grants during the nine months ended August 30, 2013 were as follows:

	Nine Months 2013
Expected life (in years)	3.2
Volatility	27 %
Risk free interest rate	0.36 %

Option activity for the nine months ended August 29, 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	(3,585)	(15,872)
Cancelled	(134)	(1,584)
Increase due to acquisition	—	273
Ending outstanding balance	3,640	7,359

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Information regarding stock options outstanding at August 29, 2014 and August 30, 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	3,640	$28.98	3.33	$156.2
Options vested and expected to vest	3,610	$29.08	3.31	$154.5
Options exercisable	3,056	$30.26	2.99	$127.3
2013				
Options outstanding	9,525	$30.80	3.10	$142.6
Options vested and expected to vest	9,359	$30.93	3.05	$138.9
Options exercisable	7,489	$32.23	2.49	$101.5

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(*) The intrinsic value is calculated as the difference between the market value as of the end of the fiscal period and the exercise price of the shares. As reported by the NASDAQ Global Select Market, the market values as of August 29, 2014 and August 30, 2013 were $71.90 and $45.75, respectively.

Summary of Employee Stock Purchase Plan Shares

The expected life of the 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 nine months ended August 29, 2014 and August 30, 2013 were as follows:

	Three Months		Nine Months	
	2014	2013	2014	2013
Expected life (in years)	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0
Volatility	26 - 27%	27 - 29%	26 - 28%	26 - 30%
Risk free interest rate	0.06 - 0.47%	0.09 - 0.34%	0.06 - 0.47%	0.09 - 0.34%

Employees purchased 2.9 million shares at an average price of $34.76 and 3.4 million shares at an average price of $25.71 for the nine months ended August 29, 2014 and August 30, 2013, respectively. The intrinsic value of shares purchased during the nine months ended August 29, 2014 and August 30, 2013 was $93.4 million and $58.5 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.

Compensation Costs

As of August 29, 2014, there was $468.0 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock-based awards which will be recognized over a weighted average period of 1.7 years. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

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Total stock-based compensation costs that have been included in our Condensed Consolidated Statements of Income for the three months ended August 29, 2014 and August 30, 2013 were as follows (in thousands):

Income Statement Classifications	2014 Option Grants and Stock Purchase Rights	2014 Restricted Stock and Performance Share Awards	2013 Option Grants and Stock Purchase Rights	2013 Restricted Stock and Performance Share Awards
Cost of revenue—subscription	$458	$1,451	$380	$1,245
Cost of revenue—services and support	1,064	1,666	878	2,609
Research and development	4,151	26,100	4,786	25,736
Sales and marketing	4,492	25,447	4,617	24,309
General and administrative	1,682	16,502	1,858	14,606
Total	$11,847	$71,166	$12,519	$68,505

Total stock-based compensation costs that have been included in our Condensed Consolidated Statements of Income for the nine months ended August 29, 2014 and August 30, 2013 were as follows (in thousands):

Income Statement Classifications	2014 Option Grants and Stock Purchase Rights	2014 Restricted Stock and Performance Share Awards	2013 Option Grants and Stock Purchase Rights	2013 Restricted Stock and Performance Share Awards
Cost of revenue—subscription	$1,424	$4,261	$1,463	$3,489
Cost of revenue—services and support	2,759	4,886	2,559	7,419
Research and development	12,397	78,567	15,340	74,677
Sales and marketing	13,571	76,541	16,177	72,087
General and administrative	4,962	49,443	6,518	44,361
Total	$35,113	$213,698	$42,057	$202,033

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 August 29, 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.

Summary of Restructuring Plans

The following table sets forth a summary of restructuring activities related to all of our restructuring plans during the nine months ended August 29, 2014 (in thousands):

	November 29, 2013	Costs Incurred	Cash Payments	Other Adjustments	August 29, 2014
Termination benefits	$2,233	$—	$(1,363)	$(262)	$608
Cost of closing redundant facilities	11,655	528	(4,761)	97	7,519
Total restructuring plans	$13,888	$528	$(6,124)	$(165)	$8,127

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Accrued restructuring charges of $8.1 million as of August 29, 2014 includes $2.3 million recorded in accrued restructuring, current and $5.8 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 40% will be paid through 2015.

NOTE 10. STOCKHOLDERS' EQUITY

Retained Earnings

The changes in retained earnings for the nine months ended August 29, 2014 were as follows (in thousands):

Balance as of November 29, 2013	$6,928,964
Net income	180,259
Re-issuance of treasury stock	(258,433)
Balance as of August 29, 2014	$6,850,790

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 August 29, 2014 were as follows (in thousands):

	November 29, 2013	Increase / Decrease	Reclassification Adjustments	August 29, 2014
Net unrealized gains on available-for-sale securities:				
Unrealized gains on available-for-sale securities	$ 10,178	$1,596	$ (3,534)	$8,240
Unrealized losses on available-for-sale securities	(937)	70	54	(813)
Net unrealized gains on available-for-sale securities	9,241	1,666	(3,480) [1]	7,427
Net unrealized gains on derivative instruments designated as hedging instruments	5,367	11,976	(6,490) [2]	10,853
Cumulative foreign currency translation adjustments	31,495	(29,708)	—	1,787
Total accumulated other comprehensive income, net of taxes	$ 46,103	$(16,066)	$ (9,970)	$20,067

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

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The following table sets forth the taxes related to each component of other comprehensive income for the three and nine months ended August 29, 2014 and August 30, 2013 (in thousands):

	Three Months		Nine Months Ended	
	2014	2013	2014	2013
Available-for-sale securities:				
Unrealized gains / losses	$68	$117	$37	$151
Reclassification adjustments	(3)	(2)	(6)	(2)
Subtotal available-for-sale securities	65	115	31	149
Derivatives designated as hedging instruments:				
Unrealized gains on derivative instruments*	—	—	—	—
Reclassification adjustments*	—	—	—	—
Subtotal derivatives designated as hedging instruments	—	—	—	—
Foreign currency translation adjustments	(1,577)	372	(474)	(128)
Total taxes, other comprehensive income	$(1,512)	$487	$(443)	$21

(*) 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 nine months ended August 29, 2014 and August 30, 2013, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling $475.0 million and $700.0 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 nine months ended August 29, 2014, we repurchased approximately 9.0 million shares at an average price of $62.42 through structured repurchase agreements entered into during fiscal 2013 and the nine months ended August 29, 2014. During the nine months ended August 30, 2013, we repurchased approximately 13.7 million shares at an average price of $43.78 through structured repurchase agreements entered into during 2012 and the nine months ended August 30, 2013.

As of August 29, 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 August 29, 2014, $42.3 million of prepayment remained under this agreement.

Subsequent to August 29, 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, $200.0 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 nine months ended August 29, 2014 and August 30, 2013 (in thousands, except per share data):

	Three Months		Nine Months Ended	
	2014	2013	2014	2013
Net income	$44,686	$83,002	$180,259	$224,665
Shares used to compute basic net income per share	498,468	504,116	497,782	502,039
Dilutive potential common shares:				
Unvested restricted stock and performance share awards	7,558	7,198	8,611	7,851
Stock options	1,785	2,744	2,182	3,265
Shares used to compute diluted net income per share	507,811	514,058	508,575	513,155
Basic net income per share	$0.09	$0.16	$0.36	$0.45
Diluted net income per share	$0.09	$0.16	$0.35	$0.44

For the three and nine months ended August 29, 2014, there were no options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of $70.49 and $65.15, respectively, that would have been anti-dilutive. Comparatively, for the three and nine months ended August 30, 2013, options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of $46.05 and $42.56 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.

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 agreement for the Almaden Tower is effective through March 2017. We are the investors in the lease receivable related to the Almaden Tower lease in the amount of $80.4 million, which is recorded as investment in lease receivable on our Condensed Consolidated Balance Sheets. As of August 29, 2014, the carrying value of the lease receivable related to the Almaden Tower approximated fair value. Under the agreement for the Almaden Tower, we have the option to purchase the building at any time during the lease term for $103.6 million. If we purchase the building, the investment in the lease receivables may be credited against the purchase price. The residual value guarantee under the Almaden Tower obligation is $89.4 million.

The Almaden Tower lease is subject to standard covenants including certain financial ratios that are reported to the lessor quarterly. As of August 29, 2014, we were in compliance with all of the covenants. In the case of a default, the lessor may demand we purchase the building for an amount equal to the lease balance, or require that we remarket or relinquish the building. If we choose to remarket or are required to do so upon relinquishing the building, we are bound to arrange the sale of the building to an unrelated party and will be required to pay the lessor any shortfall between the net remarketing proceeds and the lease balance, up to the residual value guarantee amount less our investment in lease receivable. The Almaden Tower lease qualifies for operating lease accounting treatment and, as such, the building and the related obligation are not included in our Condensed Consolidated Balance Sheets.

In August 2014, we exercised our option to purchase the East and West Towers for a total purchase price of $143.2 million. Upon purchase, our investment in the lease receivable of $126.8 million was credited against the total purchase price and we were no longer required to maintain a standby letter of credit as stipulated in the East and West Towers lease agreement. We capitalized the East and West Towers as property and equipment on our Condensed

Consolidated Balance Sheets at $144.1 million, the lesser of cost or fair value, which represented the total purchase price plus other direct costs associated with the purchase. These buildings will be depreciated over their useful life of 40 years on a straight-line basis.

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.

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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 August 8, 2014, the Court rejected the settlement agreement jointly submitted by the parties. Trial in this matter is

currently scheduled for January 2015. 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.

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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, and commenced on August 1, 2010. During the nine months ended August 29, 2014, we made both semi-annual interest payments on our Notes totaling $62.2 million. In June 2014, we entered into interest rate swaps with a total notional amount of $900.0 million designated as a fair value hedge related to our 2020 Notes. The effect of such interest rate swaps is to effectively convert the fixed interest rate on our 2020 Notes to a floating interest rate based on the LIBOR plus a fixed number of basis points. Under the terms of the swap, we will pay monthly interest at the one-month LIBOR floating interest plus a spread of a fixed number of basis points on the $900 million notional amount. In exchange, we will receive 4.75% fixed rate interest from the swap counterparties. See Note 5 for further details regarding our interest rate swap derivatives.

The gains and losses related to changes in the fair value of the interest rate swaps are included in interest and other income (expense), net in our Condensed Consolidated Statement of Income and substantially offset the changes in the fair value of the hedged portion of the underlying debt that are attributable to the changes in market risk. The fair value of the interest rate swaps is reflected in other assets in our Condensed Consolidated Balance Sheets. The carrying value of the 2020 Notes was adjusted by an amount that is equal and offsetting to the fair value of the swaps. The interest receivable from the swaps based on the fixed interest rate and the interest payable based on the effective interest rates are recorded at gross in the prepaid expenses and other current assets account and accrued expenses account, respectively, in our and Condensed Consolidated Balance Sheets.

Based on quoted prices in inactive markets, the fair value of the Notes was $1.6 billion as of August 29, 2014. The total fair value of $1.6 billion excludes the effect of fair value hedge of the 2020 Notes for which we entered into interest rate swaps for the total notional amount $900.0 million.

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

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assets and to enter into sale and leaseback transactions, subject to significant allowances. As of August 29, 2014, we were in compliance with all of the covenants.

During the first quarter of fiscal 2014, we reclassified $599.9 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) 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.

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 August 29, 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 August 29, 2014, our capital lease obligations of $6.5 million are presented as current debt in our Condensed Consolidated Balance Sheets.

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NOTE 14. NON-OPERATING INCOME (EXPENSE)

Non-operating income (expense) for the three and nine months ended August 29, 2014 and August 30, 2013 included the following (in thousands):

	Three Months		Nine Months Ended	
	2014	2013	2014	2013
Interest and other income (expense), net:				
Interest income	$5,274	$5,332	$15,649	$16,620
Foreign exchange gains (losses)	(5,094)	(3,847)	(12,160)	(15,438)
Realized gains on fixed income investment	1,047	986	2,971	3,385
Realized losses on fixed income investment	(13)	(1,032)	(49)	(1,059)
Other	240	293	751	738
Interest and other income (expense), net	$1,454	$1,732	$7,162	$4,246
Interest expense	$(13,361)	$(16,747)	$(47,054)	$(50,786)
Investment gains (losses), net:				
Realized investment gains	$145	$864	$878	$1,359
Unrealized investment gains	524	—	989	214
Realized investment losses	—	(2,034)	(1,054)	(7,049)
Unrealized investment losses	—	(909)	—	—
Investment gains (losses), net	$669	$(2,079)	$813	$(5,476)
Non-operating income (expense), net	$(11,238)	$(17,094)	$(39,079)	$(52,016)

NOTE 15. SEGMENTS

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

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

We have the following reportable segments:

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