

We have set out in this annual report to discuss the emerging electronic publishing industry and to demonstrate some of the capabilities of the Interleaf system.

Interleaf, Inc. develops and markets electronic publishing systems and software for the technical documentation, office automation and graphic arts markets. Interleaf systems allow users to compose, edit and print complex documents containing multi-font text and graphics, including computer-aided-design (CAD) drawings, charts, diagrams, photographs, line art and free-hand drawings.

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This was a strong growth year for Interleaf. Our revenues doubled, our bottom line improved sharply – we were profitable in the third and fourth quarters – and we announced a set of new products that will run on standard PCs and mainframes to create a unique corporate-wide electronic publishing solution.

Interleaf's net income for the fourth quarter (ended March 31) of its 1987 fiscal year increased 149% to \$642,000 from \$258,000 a year earlier. Revenues for the quarter increased 74% to \$11.8 million from \$6.8 million for last year's period. Revenues for all of fiscal 1987 were \$37.2 million, an increase of 100% from \$18.6 million for fiscal 1986. Losses for the year were \$410,000, compared with \$2.4 million for fiscal 1986.

"Every once in a while, a company announces not just a product or a corporate strategy, but an ambitious plan that breaks new ground for an industry – if it works. Interleaf, one of Massachusetts' major new electronic publishing companies, made that kind of announcement in mid-March." So wrote *Mass. High Tech* when we announced a new product direction, which will provide the means for corporations to standardize using Interleaf on everything from PCs to mainframe computers.

Interleaf's corporate-wide solution, explained in more detail in the essay following this letter, includes a host of products, some currently available and others under development. Multi-Lingual Publishing Software will let users work in up to 12 different languages simultaneously. A new mainframe version will run under IBM VM and MVS and Digital VAX/VMS operating systems. This will enable Interleaf systems to manage extremely large document data bases – a pressing need for automotive, aerospace and pharmaceutical companies, among others.

A text-only version of Interleaf will run on off-the-shelf PCs, adding cost-effective seats to a network. A viewstation will enable PCs to act as a read-only workstation. It can be used to electronically distribute information from one central location; for example, a point-of-sale catalog.

Release 4.0 of Interleaf's high-end product, Technical Publishing Software, will have sophisticated graphics features such as spot color, as well as the ability to control a document's style from one centralized location, no matter how many writers work on it – a feature important to the technical documentation market.

Financial Highlights

Year ended March 31		1987	1986	1985
For the year	Revenues	\$37,173,162	\$18,645,883	\$8,334,586
	Net loss	(410,121)	(2,443,401)	(1,628,509)
At year end	Working capital	27,190,948	7,958,750	2,777,511
	Total assets	44,734,377	18,676,887	8,642,585
	Total shareholders' equity	35,290,459	11,020,251	4,475,754
	Number of employees	355	221	157

The corporate-wide solution is a significant advance because it allows companies and government agencies – for the first time – to employ electronic publishing at every level of the organization, at every phase of the document development cycle.

The growth in our revenues this year can be largely attributed to the Interleaf direct sales force, whose productivity nearly doubled. We plan to substantially increase the size of the sales force in fiscal 1988.

Our OEM and third-party marketing relationships with such companies as IBM, Digital Equipment Corporation, Eastman Kodak, Apollo and Siemens AG continue to be important to our distribution strategy. Our ability to sell electronic publishing solutions on a variety of hardware platforms through a variety of channels has given us a key competitive advantage, and we believe the investment we have made to support these channels will play a significant role in our long-term growth.

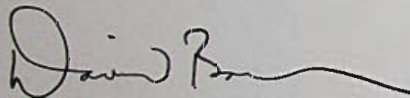
Digital Equipment Corporation last year selected Interleaf to participate in its System Cooperative Marketing Partner (SCMP) Program. This means Digital's nationwide sales force assists in sales of Interleaf's turn-key systems running on Digital workstations.

We announced two new third-party sales agreements, one with Electronic Data Systems (EDS), a GM subsidiary, and the other with GTE Directories Corporation. Both of these contracts represent significant opportunities for Interleaf. EDS will offer Interleaf technology to the nation's largest industrial company, and GTE has introduced us to a new market – directory display advertising.

1987 marked our expansion in the European market with the opening of Interleaf France S.A. We expect to open sales offices in the United Kingdom, Italy and West Germany in fiscal 1988.

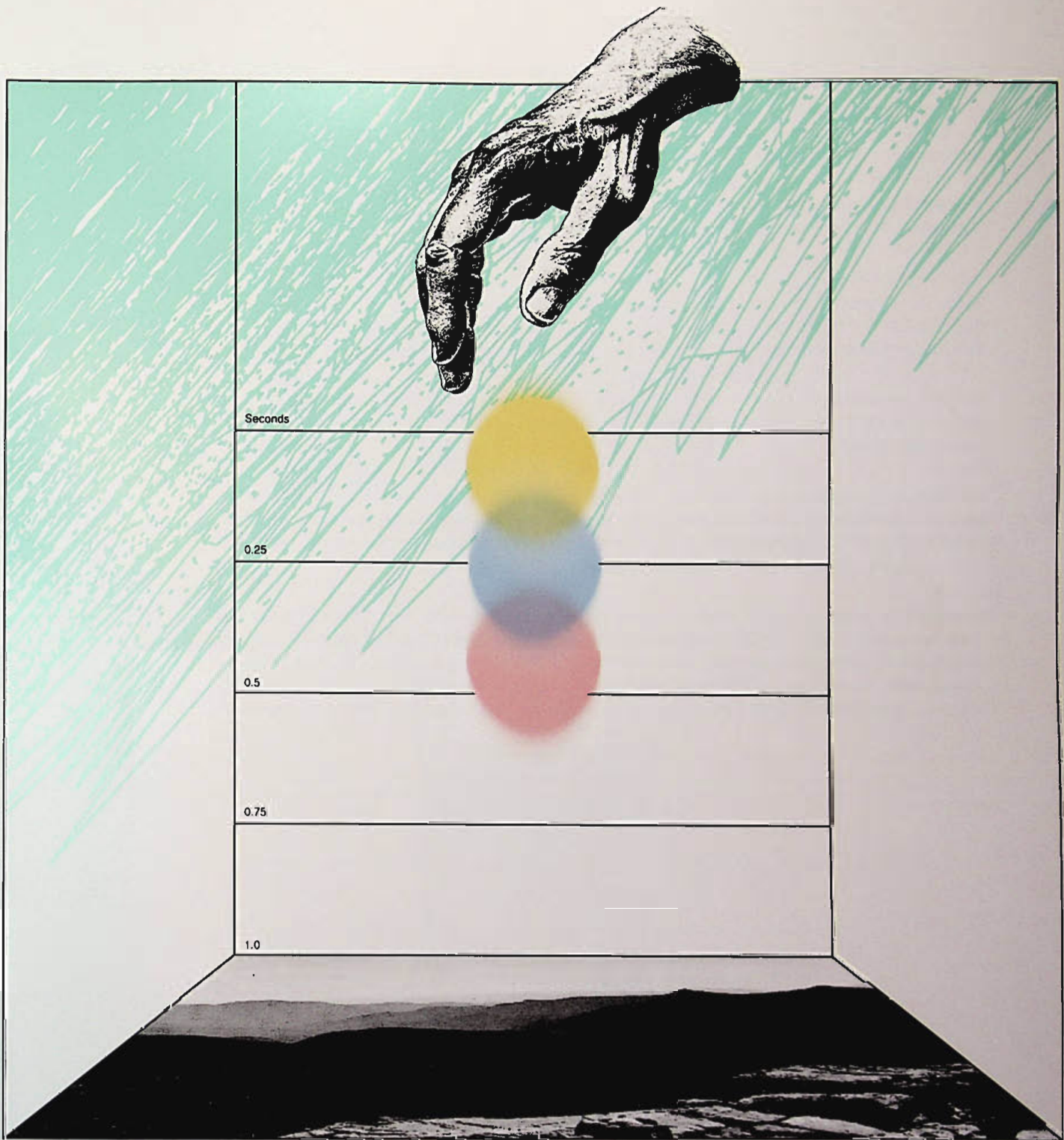
We raised \$24 million with an initial public offering of Interleaf stock in June 1986. In March 1987, we entered into an arrangement with ML Technology Ventures, L.P. (MLTV) for funding of our PC and international product development. MLTV, an R&D limited partnership sponsored by Merrill Lynch Capital Markets, will provide Interleaf with \$3.5 million in funding through September 1988. The conditions of this arrangement are discussed in greater detail in the Notes to Consolidated Financial Statements, beginning on page 17.

These are still the early days of the electronic publishing industry. Analysts have estimated compounded annual market growth at between 35 and 70%. We believe Interleaf is well-positioned to be an important participant in that growth.



David A. Boucher, President
June 1987

To create the illustration at right, the hand, ball and landscape were scanned with an image scanner and edited using crop, rotate and shear functions. Rules, type and free-hand drawing were added on-line.



Interleaf electronic publishing provides dramatic increases in productivity. Make a revision that alters an entire document, and by the time the ball hits the ground the Interleaf system will have updated 100 pages.

Fortune 500 companies typically spend between three and ten percent of their annual revenues producing printed pages. By using Interleaf electronic publishing technology to automate this process, it is possible for corporations to do their publishing at half the cost and in one-fourth the time, as compared to traditional methods.

Electronic publishing is a new industry that is on the verge of revolutionizing the way business creates documents. Why now and not, say, ten years ago?

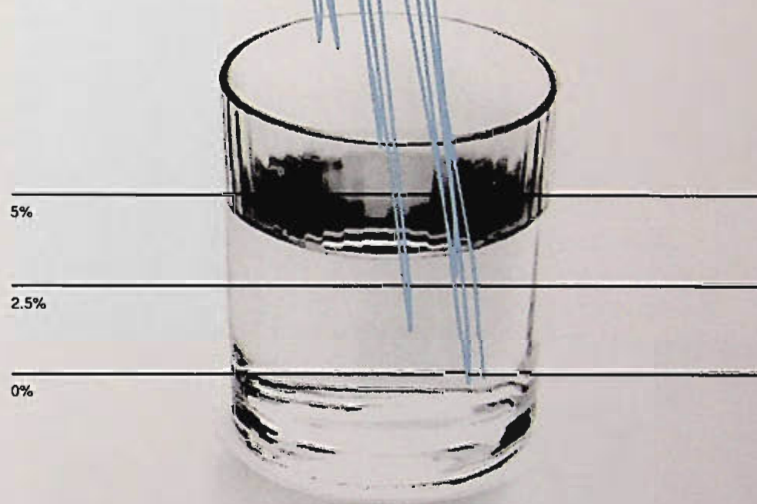
Word processors could place only characters on pages, not the microscopic dots of which computerized graphics are made. To handle text and graphics mixed in a single document – without laborious manual cutting and pasting – three technology breakthroughs were necessary: powerful computers to prepare the pages, laser printers to print them, and the software to make it work.

By 1981, we could see that low-cost 32-bit computers and laser printers would soon become available. In 1984, after three years of research and development, Interleaf introduced its electronic publishing software.

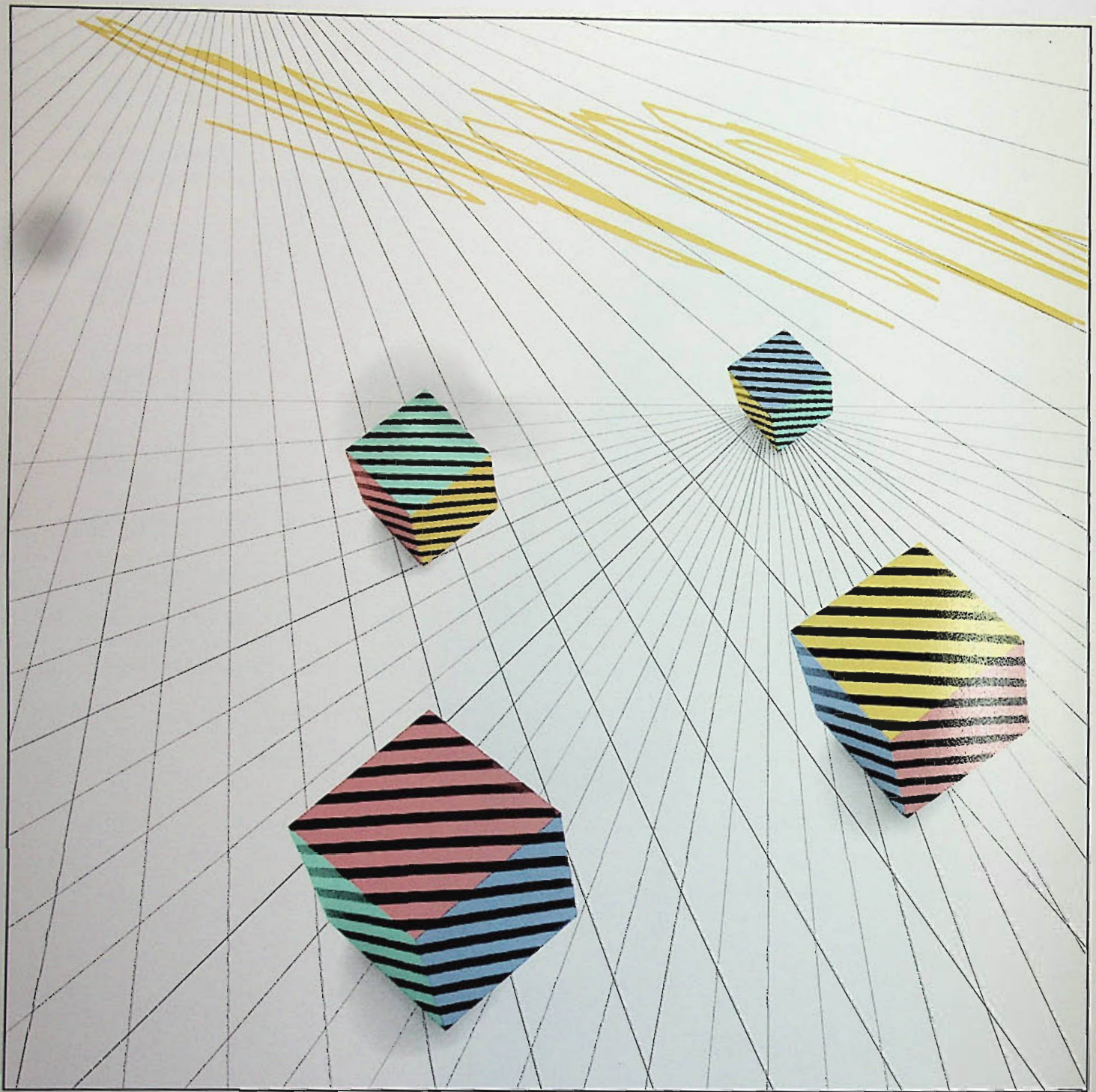
Interleaf electronic publishing technology gives writers advanced, exceptionally fast word processing. Moreover, because the graphics capabilities are always a click of a button away, the writer no longer needs to think in purely verbal terms; he considers the impact of typeface and layout, and can add graphic elements whenever and wherever he wants.

With Interleaf, users can create charts automatically from data or spreadsheets. They can make their own drawings, and bring others in from computer-aided-design systems. Interleaf users can include photographs in a document and alter them instantly. Everything – text, graphics and photographs – can be stored, recalled and edited. Such revisions are so simple, they can often be completed with the strike of a single key, even if the computer has to change every page in a multi-volume document.

The illustration at right was made by scanning photographs of the waterfall and glass; both were enhanced with on-line image editing tools. Text and free-hand drawing were then added.



How large is the electronic publishing market? Fortune 500 companies typically spend between three and ten percent of their revenues on publishing. Analysts say this market could reach between \$4 and \$6 billion by 1990, with current penetration estimated at under five percent.



Interleaf provides a software standard that runs on computers from IBM, Digital, Sun and Apollo – a uniform publishing solution that lets users of all four computers share documents with no delay and no loss of data.

The photographs of the cubes at left were scanned and airbrushed using paint and blend. The grids were created from a single line that was duplicated and rotated. Color accents were added with the on-line graphics editor.

Electronic publishing is as important a leap over word processing as word processing was over typing. Electronic publishing is an even broader application than word processing because word processing affects only those who use words while electronic publishing affects all who use words and pictures. And it brings the power and efficiency of typography to a new world of users.

Electronic publishing is changing the very market into which it sells, blurring previously distinct segments – word processing, graphic arts, typesetting. This makes estimating market size difficult, though analysts say it could reach between \$4 and \$6 billion in 1990.

Interleaf "wrote the book on electronic publishing," said *Business Week*. Our revenues have doubled each year since we began shipping product in May 1984. In fiscal 1987, we met our key goals, including becoming profitable in the second half.

Here are a few examples of how our customers are using Interleaf:

BellSouth Services is using Interleaf electronic publishing as an office automation tool for producing memos, handbooks, reports – spanning a full range of office communications.

The U.S. Department of Transportation's Automated Applications Division saw turnaround time for manuals go from 6–12 months to 3–4 months using Interleaf.

The faculty and administration at George Mason University use Interleaf to tie together a wide variety of computers, creating everything from scholarly books to course schedules.

GTE Directories Corporation uses Interleaf's graphics capabilities to produce display ads for Yellow Pages telephone directories. According to GTE, "Over the past two years, we have actively sought the next evolutionary step in state-of-the-art ad creation. The Interleaf system is it."

In March 1987, Interleaf announced a product strategy designed to allow corporations to unify the widespread document production process, and to centrally merge large document databases.

Our corporate-wide solution consists of software products running on the computers already in use by business and government. In addition to our current workstation-based product, we will have software for personal computers that makes it easy and cost-effective to tie large numbers of writers into a corporate publishing network. We also announced a version running on mainframes (the largest corporate computers) that will let users create, revise, store, track, manage and print very long documents – even documents hundreds of thousands of pages long, as required, for example, by automotive, aerospace and pharmaceutical companies.

The Interleaf corporate-wide solution allows documents created anywhere in a corporation to be passed around electronically from writer to artist, to strategic planner, to marketer, to financial executive, to lawyer, to engineer, to shop floor, to retail outlet.

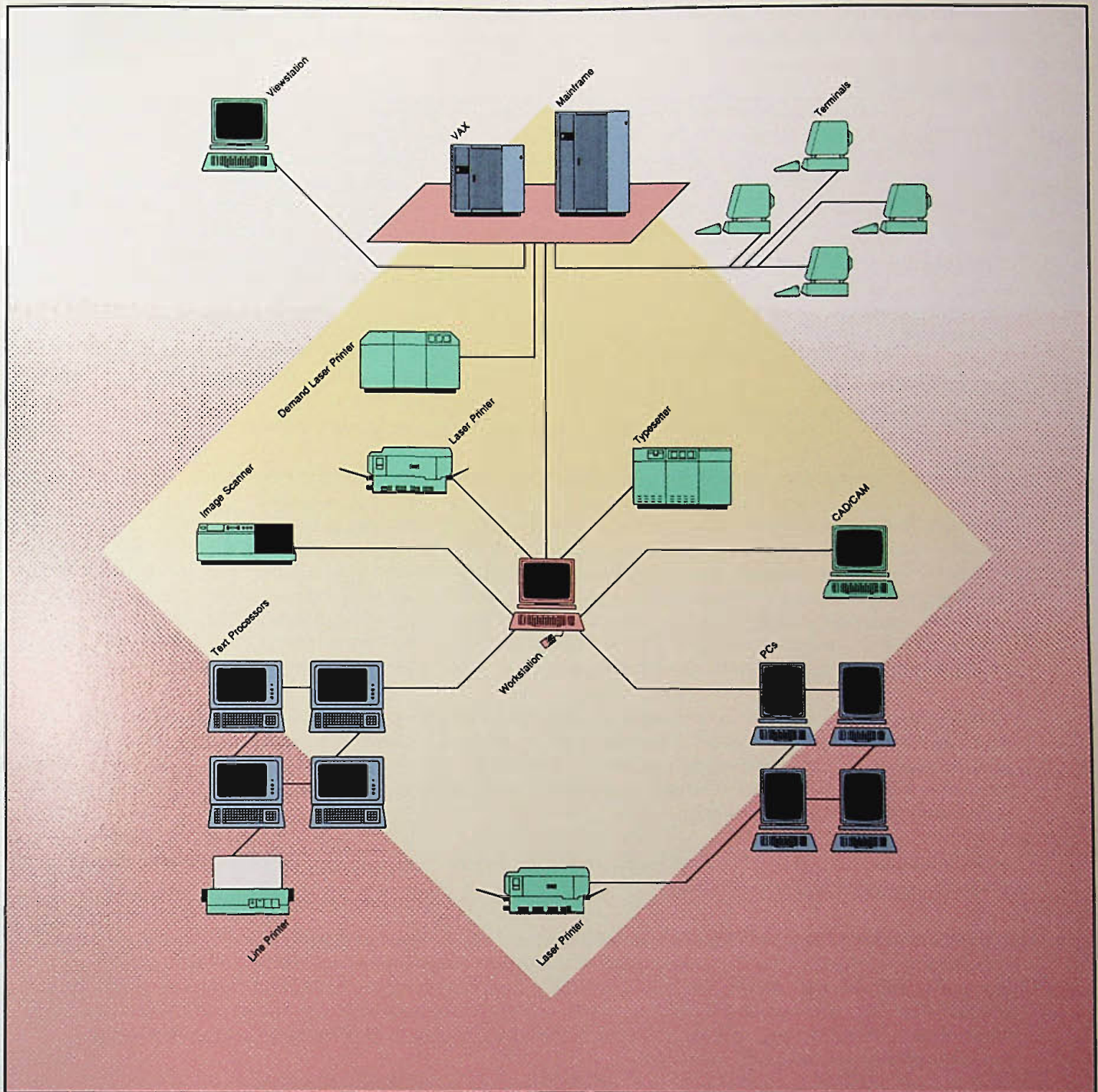
We have also announced software that will let users create multi-lingual documents, important both in the European market and for multinational corporations.

This is a uniquely rich set of products, running on off-the-shelf hardware – computers from Digital Equipment Corporation, IBM, Sun Microsystems and Apollo Computer.

With its corporate-wide solution, Interleaf will fundamentally enlarge its market opportunity with offerings that, for the first time, enable even the largest corporations and government agencies to employ electronic publishing at every stage of the document production cycle, on the full range of business computers, and simultaneously in different languages.

With total market penetration estimated at under five percent, the real opportunity clearly lies ahead.

The illustration at right was created with Interleaf's on-line text and drawing tools. The background pattern was scanned as a continuous tone.



Interleaf's new corporate-wide publishing solution will use the full range of business computers to link the engineer, the scientist, the documentation writer, the graphic artist, the marketing manager, the patent attorney, the secretary, the accountant, the strategic planner and the financial executive to a single document production network.

Results of Operations. The following table sets forth selected financial data included in the Consolidated Statements of Operations for the three fiscal years ended March 31, 1987 as a percentage of revenues:

Year ended March 31	1987	1986	1985
Revenues	100%	100%	100%
Costs and expenses			
Cost of products and services sold	44	41	34
Selling, general and administrative	43	51	65
Research and development	15	19	20
Total operating costs and expenses	102	111	119
Loss from operations	(2)	(11)	(19)
Interest income (expense), net	1	(1)	(1)
Loss before income taxes	(1)	(12)	(20)
Provision for foreign income taxes	—	1	—
Net loss	(1%)	(13%)	(20%)

Revenues. Total revenues for the years ended March 31, 1985, 1986 and 1987 were \$8.3 million, \$18.6 million and \$37.2 million, respectively. The annual increases in the Company's revenues have resulted from several factors, including the introduction of new products, enhancements to existing products, the expansion of the Company's sales operations and the increased market awareness and acceptance of computer-aided publishing and the Company's products. Sales of systems and software increased \$16.4 million (117%) from 1986 to 1987, \$9.3 million (191%) from 1985 to 1986, and \$4.8 million from 1984 to 1985 when the Company emerged from the development stage. These increases are primarily the result of both the personnel additions to the direct sales force and the opening of 21 district sales offices during this three-year period.

Software license and royalty revenue remained at generally consistent levels for 1987, 1986 and 1985. Royalties accounted for a larger portion of such revenues in 1987 compared with the prior two years due to increased volume of shipments of products covered by OEM agreements entered into in 1985 and 1986. Through 1986, most OEMs had only recently begun or had not yet begun to ship products under such agreements. Consequently, most of such revenues in 1985 and 1986 were derived from advance license payments.

Service revenues increased \$1,873,000, \$638,000 and \$71,000 for 1987, 1986 and 1985, respectively. These increases reflect the growing installed base of customers.

Cost of Products and Services Sold. Cost of products and services sold increased as a percentage of total revenues during the three years ended March 31, 1987 as sales of systems and software represented a progressively increasing percentage of total revenues (82% in 1987, 76% in 1986 and 58% in 1985) during that period. The increases of \$8,563,000, \$4,904,000 and \$2,789,000 for 1987, 1986 and 1985, respectively, reflect the hiring of additional employees to assemble and test components and systems, increased costs of materials resulting from the higher unit volume and the addition of support personnel to service the growing installed base of customers.

Selling, General and Administrative. Selling, general and administrative expenses increased \$6,678,000, \$4,154,000 and \$4,349,000 during 1987, 1986 and 1985, respectively, but decreased as a percentage of revenues to 43% in 1987 from 51% in 1986 and 65% in 1985. Selling expenses increased as a result of expanding the Company's sales and marketing staff and the opening of 21 district sales offices during this three-year period. General and administrative expenses increased during the period due to the addition of management and administrative personnel to support the Company's growth, expenses associated with the Company's move into new headquarters during the third quarter of fiscal 1986 and increased professional fees.

Research and Development. Research and development expenses increased \$2,095,000, \$1,810,000 and \$979,000 during 1987, 1986 and 1985, respectively, but decreased as a percentage of revenues from 20% in 1985 to 19% in 1986, and 15% in 1987. During fiscal 1987 the Company adopted the provisions of Financial Accounting Standards Board Statement Number 86 and capitalized certain research and development costs as described in Note B of Notes to Consolidated Financial Statements. The Company is committed to a high level of research and development expenses and the increase in expense during the three-year period is primarily attributable to an increase in personnel as new products and enhancements to existing products were developed and introduced to the marketplace. The decreases as a percentage of revenues were primarily due to the increased level of revenues.

Interest Income and Expense. Interest income and interest expense are summarized in Note O of Notes to Consolidated Financial Statements. The net interest income for 1987 resulted primarily from the investment of funds obtained from the Company's initial public offering in June 1986.

Effects of Inflation. The Company believes inflation has not had a material effect on its results of operations to date.

Liquidity and Capital Resources. In June 1986, the Company sold 2,650,000 shares of common stock at \$10 per share in its initial public offering yielding net proceeds to the Company of \$24,143,511. Prior to this, the Company had met its liquidity and capital requirements primarily through private sales of equity securities and bank borrowings. At March 31, 1987, the Company had working capital of approximately \$27,191,000 including approximately \$15.3 million in cash and cash equivalents. The Company also has available approximately \$10 million under a bank line of credit. See Note D of Notes to Consolidated Financial Statements. As revenues grow, cash requirements for accounts receivable and inventory will increase. The Company believes that its cash needs for at least fiscal 1988 can be satisfied from the existing cash balances and cash from operations.

**Selected Five-Year
Financial Data**

Year ended March 31		1987	1986	1985	1984	1983
For the year	Total operating revenues	\$37,173,162	\$18,645,883	\$8,334,586	\$ 319,120	\$ 6,406
	Net loss	(410,121)	(2,443,401)	(1,628,509)	(1,460,839)	(329,242)
	Net loss per share	(.04)	(.29)	(.26)	(.31)	(.13)
At year end	Total assets	44,734,377	18,676,887	8,642,585	1,655,714	522,967
	Long-term obligations	1,362,892	1,901,608	1,369,848	104,993	77,291
	Total shareholders' equity	35,290,459	11,020,251	4,475,754	891,622	336,129

See Note B of Notes to Consolidated Financial Statements for discussion pertaining to the 1987 change in accounting for software development costs.

**Consolidated Statements
of Operations**

Year ended March 31	1987	1986	1985
Revenues			
Sales of systems and software	\$ 30,552,772	\$ 14,106,190	\$ 4,844,225
Software license and royalty revenues	3,287,079	3,357,158	3,347,980
Service revenues	2,581,074	708,363	70,795
Other income	752,237	474,172	71,586
	37,173,162	18,645,883	8,334,586
Costs and expenses			
Cost of products and services sold	16,300,827	7,738,009	2,833,834
Selling, general and administrative	16,194,369	9,516,564	5,362,638
Research and development	5,585,634	3,490,536	1,680,693
Total operating costs and expenses	38,080,830	20,745,109	9,877,165
Loss from operations	(907,668)	(2,099,226)	(1,542,579)
Interest income (expense), net	497,547	(144,175)	(85,930)
Loss before income taxes	(410,121)	(2,243,401)	(1,628,509)
Provision for foreign income taxes	—	200,000	—
Net loss	\$ (410,121)	\$ (2,443,401)	\$ (1,628,509)
Net loss per share	\$ (.04)	\$ (.29)	\$ (.26)
Shares used in computing net loss per share	10,507,891	8,445,028	6,350,923

See notes to consolidated financial statements.

March 31	1987	1986
Assets		
Current assets		
Cash and cash equivalents	\$ 15,288,837	\$ 3,654,101
Accounts receivable, net of allowance for doubtful accounts of \$425,000 and \$60,000, respectively	10,719,261	5,227,798
Inventories	8,483,766	3,888,255
Prepaid expenses and other current assets	474,638	573,188
Total current assets	34,966,502	13,343,342
Equipment and improvements, net	8,515,019	5,104,651
Other assets	1,252,856	228,894
	\$ 44,734,377	\$ 18,676,887
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	\$ 4,590,102	\$ 3,591,862
Accrued expenses	1,049,006	242,901
Accrued compensation and related items	937,495	756,145
Unearned service revenues	661,012	248,271
Current portion of long-term debt	500,856	512,832
Current portion of capital lease obligation	37,083	32,581
Total current liabilities	7,775,554	5,384,592
Long-term debt, less current portion	835,064	1,336,697
Capital lease obligation, less current portion	527,828	564,911
Unearned revenue	305,472	370,436
Shareholders' equity		
Preferred stock, par value \$.10 per share, authorized 5,000,000 shares, issued and outstanding as follows:		
Convertible preferred stock		
Series C, authorized, issued and outstanding 1,777,778 shares in 1986	-	177,778
Series D, authorized, issued and outstanding 921,092 shares in 1986	-	92,109
Series E, authorized, issued and outstanding 1,501,838 shares in 1986	-	150,184
Common stock, par value \$.01 per share, authorized 20,000,000 shares, issued and outstanding 11,208,534 shares (4,260,702 shares in 1986)	112,085	42,607
Additional paid-in capital	41,481,160	16,450,238
Accumulated deficit	(6,302,786)	(5,892,665)
	35,290,459	11,020,251
	\$ 44,734,377	\$ 18,676,887

See notes to consolidated financial statements.

Changes in Shareholders' Equity

	Series C	Convertible Preferred Stock Series D	Convertible Preferred Stock Series E
Balances at April 1, 1984	\$ 88,889	—	—
Stock split in the form of a dividend (888,889 shares Convertible Preferred Stock – Series C and 2,020,563 shares common stock)	88,889	—	—
Net proceeds from sale of 921,092 shares of Convertible Preferred Stock – Series D	—	\$92,109	—
Common stock issued in connection with incentive stock options exercised by employees	—	—	—
Net loss	—	—	—
Balances at March 31, 1985	177,778	92,109	—
Net proceeds from sale of 1,501,838 shares of Convertible Preferred Stock – Series E	—	—	\$150,184
Common stock issued in connection with incentive stock options exercised by employees	—	—	—
Repurchase of 57,500 shares of common stock	—	—	—
Net proceeds from sale of 57,500 shares of common stock to employees	—	—	—
Net loss	—	—	—
Balances at March 31, 1986	177,778	92,109	150,184
Conversion of Convertible Preferred Stock into common stock	(177,778)	(92,109)	(150,184)
Net proceeds from sale of 2,650,000 shares of common stock in initial public offering	—	—	—
Common stock issued in connection with incentive stock options exercised by employees	—	—	—
Proceeds from sale of warrant	—	—	—
Net loss	—	—	—
Balances at March 31, 1987	—	—	—

See notes to consolidated financial statements.

Common Stock	Additional Paid-in Capital	Accumulated Deficit	Total Shareholders' Equity
\$ 20,206	\$ 2,603,282	\$(1,820,755)	\$ 891,622
20,206	(109,095)	-	-
-	5,000,741	-	5,092,850
1,913	117,878	-	119,791
-	-	(1,628,509)	(1,628,509)
42,325	7,612,806	(3,449,264)	4,475,754
-	8,816,779	-	8,966,963
282	20,653	-	20,935
(575)	(286,925)	-	(287,500)
575	286,925	-	287,500
-	-	(2,443,401)	(2,443,401)
42,607	16,450,238	(5,892,665)	11,020,251
42,007	378,064	-	-
26,500	24,117,011	-	24,143,511
971	157,722	-	158,693
-	378,125	-	378,125
-	-	(410,121)	(410,121)
\$112,085	\$41,481,160	\$(6,302,786)	\$35,290,459

Year ended March 31	1987	1986	1985
Provided from (used in) operations			
Net loss	\$ (410,121)	\$(2,443,401)	\$(1,628,509)
Non-cash items included in operations:			
Depreciation	1,841,775	1,055,705	434,838
Amortization	148,309	38,648	24,510
Cash provided from (used in) operations	1,579,963	(1,349,048)	(1,169,161)
Changes in operating working capital:			
Accounts receivable	(5,491,463)	(3,123,635)	(2,104,163)
Inventories	(4,595,511)	(1,147,203)	(2,538,471)
Prepaid expenses and other current assets	98,550	(445,514)	(94,586)
Accounts payable	998,240	2,266,066	1,092,910
Accrued expenses	806,105	156,626	72,162
Accrued compensation and related items	181,350	375,970	267,498
Unearned service revenues	412,741	181,077	67,194
Net cash used in operations	(6,010,025)	(3,085,661)	(4,406,617)
Other uses of cash			
Additions to equipment and improvements, net	(5,252,143)	(2,863,040)	(3,054,688)
(Increase) decrease in other assets	(1,172,271)	13,743	(228,057)
Increase (decrease) in unearned revenue	(64,964)	(140,074)	270,510
	(12,499,403)	(6,075,032)	(7,418,852)
Cash provided by (used in) financing activities			
Net proceeds from sale of common stock in initial public offering	24,143,511	—	—
Net proceeds from sale of Convertible Preferred Stock – Series E	—	8,966,963	—
Net proceeds from sale of Convertible Preferred Stock – Series D	—	—	5,092,850
Net proceeds from sale of common stock	158,693	308,435	119,791
Proceeds from sale of warrant	378,125	—	—
Repurchase of common stock	—	(287,500)	—
Proceeds from long-term debt	—	553,482	1,810,907
Decrease in long-term debt	(513,609)	(500,834)	(178,442)
Increase (decrease) in capital lease obligation	(32,581)	597,492	—
Total cash provided from financing activities	24,134,139	9,638,038	6,845,106
Net increase (decrease) in cash and cash equivalents	11,634,736	3,563,006	(573,746)
Cash and cash equivalents at beginning of year	3,654,101	91,095	664,841
Cash and cash equivalents at end of year	\$15,288,837	\$ 3,654,101	\$ 91,095

See notes to consolidated financial statements.

Note A / Significant Accounting Policies

Business. The Company, a Massachusetts corporation, was incorporated on May 27, 1981, to design, develop and market turn-key systems and software for computer-aided publishing applications.

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Affiliates. The Company's 20% investments in Interleaf Canada Inc. and Interleaf France S.A., corporate joint ventures, are accounted for on the equity basis. Results of operations for these entities through March 31, 1987 are not material.

Revenue Recognition. Revenues from the sale of equipment and software are recognized at the time of shipment. Contractual service revenues are recognized ratably over the contract period, generally one year, and noncontractual service revenues are recognized as the services are performed. Software license revenues are recognized when the Company successfully performs the obligations specified under the agreements. Royalty revenues are recognized upon notification of shipment of the Company's software by the licensee to the end user. Advance payments received under license and royalty agreements which have not been earned are classified as unearned revenue.

Inventories. Inventories are valued at the lower of cost (as determined by the average cost method, which approximates the first-in, first-out method) or market. Inventories consist principally of computer systems and related components.

Equipment and Improvements. Equipment and improvements are stated at cost. Depreciation and amortization are determined on the straight-line method over the estimated useful lives of the related assets. Expenditures for repairs and maintenance are charged to operations as incurred.

Income Taxes. The Company, when required, provides for income taxes based upon financial statement income. Investment tax credits are accounted for under the "flow-through" method.

Net Loss Per Share. Net loss per share is based on the weighted average number of common shares outstanding during the period adjusted to reflect the conversion of all outstanding shares of preferred stock into common stock.

Basis of Presentation. Certain 1986 and 1985 amounts have been reclassified to conform to the 1987 method of presentation.

Note B / Capitalized Software Development Costs

During the year beginning April 1, 1986, the Company adopted the provisions of Financial Accounting Standards Board Statement Number 86 and capitalized certain research and development costs. Costs incurred in the research, design and development of software for sale to others are charged to expense until technological feasibility is established, after which remaining software production costs are capitalized and amortized on a straight line basis over periods not to exceed three years beginning when the product is offered for sale. Prior to adopting Statement Number 86, all research and development costs were expensed as incurred.

For the year ended March 31, 1987, the Company capitalized \$746,700 of software production costs, of which \$89,774 was amortized and charged to expense and \$656,926 is included in other assets at March 31, 1987. The net effect of this change decreased the net loss by \$656,926 (\$.06 per share).

Note C / Equipment and Improvements

Equipment and improvements at March 31, 1987 and 1986 consist of the following:

	1987	1986
Development equipment	\$ 3,294,655	\$ 1,887,663
Demonstration equipment	1,965,420	1,292,029
Office equipment	2,940,919	1,268,527
Furniture	1,486,094	852,013
Leasehold improvements	2,237,784	1,392,055
	11,924,872	6,692,287
Less allowance for depreciation	3,409,853	1,587,636
	\$ 8,515,019	\$ 5,104,651

Note D / Credit Arrangements

Subsequent to March 31, 1987, the Company's credit facility with a bank was increased to \$18,500,000 (\$11,000,000 as of March 31, 1987) with \$10,000,000 in the form of a demand unsecured line of credit bearing interest at prime rate plus 1/4%, \$5,500,000 in equipment financing bearing interest at prime rate plus 1/2% and \$3,000,000 for foreign borrowings with parent company guarantees. Under the conditions of the demand line of credit, the Company may borrow up to 80% of qualified accounts receivable plus 40% (up to a maximum amount of \$1,500,000) of inventory, and is required to maintain average cash balances of 5% of the line of credit. There were no borrowings outstanding under the line of credit at March 31, 1987 and 1986.

Note E / Long-Term Debt

Long-term debt at March 31, 1987 and 1986 is as follows:

	1987	1986
Loan payable in monthly principal installments of \$18,765 plus interest at prime rate plus 3/4%	\$ 656,782	\$ 881,962
Loan payable in monthly principal installments of \$9,225 plus interest at prime rate plus 3/4%	368,982	479,682
Loan payable in monthly principal installments of \$8,500 plus interest at prime rate plus 1 1/4%	229,500	331,500
Commercial note payable in monthly principal installments of \$3,646 with interest at prime rate plus 1 1/2%	61,412	105,729
Commercial note payable in monthly principal installments of \$1,767 with interest at prime rate plus 1 1/2 %	19,244	40,640
Installment loans payable in monthly principal installments plus interest at prime rate plus 1 1/4%	-	10,016
	1,335,920	1,849,529
Less current portion	500,856	512,832
	\$ 835,064	\$ 1,336,697

Equipment with a net book value at March 31, 1987 of approximately \$1,222,000 is pledged as collateral for long-term debt.

Maturities of long-term debt during each of the next four fiscal years are as follows: 1988 - \$500,856; 1989 - \$455,539; 1990 - \$342,618; 1991 - \$36,907.

Note F / Capital Lease Obligation

In August 1984, the Company entered into a lease for a new corporate headquarters located in Cambridge, Massachusetts. The lease provided for rental payments to commence after occupancy (which occurred in November 1985). Under the terms of the agreement, the Company received an 11% conditional limited partnership interest in the building.

In connection with financing leasehold improvements at the new corporate headquarters, the Company renegotiated and amended this lease effective April 1985. The amended lease provides for increased minimum rental payments over the lease term. The present value of the increased minimum lease payments has been reflected as a capital lease obligation. The original monthly lease payments are included in the operating lease amounts presented in Note J. Amortization of these leasehold improvements has been included in depreciation.

Note G / Restricted Stock Agreements

Certain of the common stock issued by the Company through March 31, 1987 is subject to restricted stock agreements. These agreements include various repurchase options whereby, in the event of voluntary or involuntary employment termination, the Company has the option to repurchase a percentage of the terminated employees' shares at the original price. The percentage of shares subject to repurchase is based on the nature of the termination and the period of employment.

Note H / Shareholders' Equity

On July 17, 1984, the shareholders authorized the Company to increase its authorized common stock and preferred stock from 4,000,000 shares of \$.01 par value common stock and 2,250,000 shares of \$.10 par value preferred stock to 20,000,000 shares of \$.01 par value common stock and 5,000,000 shares of \$.10 par value preferred stock. The Company also authorized and effected on July 17, 1984 a 2-for-1 stock split in the form of a stock dividend for holders of Series C Convertible Preferred Stock and common stock.

During 1985, the Company issued 921,092 shares of \$.10 par value Series D Convertible Preferred Stock for \$5.54 per share. During 1986, the Company issued 1,501,838 shares of \$.10 par value Series E Convertible Preferred Stock for \$6.00 per share.

On June 26, 1986, the Company completed its initial public offering of common stock, selling 2,650,000 shares (including the underwriters' over-allotment of 450,000 shares) at \$10.00 per share. At that time pursuant to the terms of the preferred stock agreements, the Company converted the 1,777,778 shares of Series C Convertible Preferred Stock, 921,092 shares of Series D Convertible Preferred Stock and 1,501,838 shares of Series E Convertible Preferred Stock into 4,200,708 shares of common stock.

As of March 31, 1987, there remained reserved 1,131,650 shares of common stock for issuance under the Incentive Stock Option Plan, 125,000 shares of common stock for the exercise of the stock purchase warrant described in Note P, and 200,000 shares of common stock for issuance under the Employee Stock Purchase Plan described in Note I.

Note I / Stock Option and Stock Purchase Plans

During fiscal 1984, the Company established an Incentive Stock Option Plan. Under the terms of the Plan, options may be granted to key employees to purchase shares of common stock at prices not less than fair market value at date of grant. The options expire after ten years from date of grant. Options are nontransferable other than on death.

During fiscal 1985, the Plan was amended to provide for options to be exercisable in whole or in part at any time prior to expiration. Options remain subject to vesting provisions and buyback provisions by the Company in the event of voluntary or involuntary termination of the employee. At March 31, 1987, all options were exercisable.

A summary of activity in the Plan is presented below:

	Number of Shares	Price of Shares
Outstanding at April 1, 1985	357,125	\$.57 - \$ 4.00
Granted	216,050	4.00 - 4.50
Exercised	(29,901)	.57 - 4.00
Cancelled	(32,833)	.84 - 4.50
Outstanding at March 31, 1986	510,441	.57 - 4.50
Granted	401,250	4.50 - 12.00
Exercised	(97,124)	.84 - 4.50
Cancelled	(34,049)	.57 - 10.00
Outstanding at March 31, 1987	780,518	\$.57 - \$12.00

In February 1987, the Company increased the number of shares available for grant under its Incentive Stock Option Plan from 1,200,000 shares to 1,450,000 shares and in April 1987 to 1,700,000 shares. These amendments are subject to shareholder approval. At March 31, 1987, 351,132 shares were available for future grants under the Plan.

During fiscal 1987, the Company adopted, subject to shareholder approval, an Employee Stock Purchase Plan whereby eligible employees may invest up to 10% of their total compensation in shares of the Company's common stock. The purchase price of the shares is 85% of the fair market value of the stock on the offering commencement date or the offering termination date (typically six months after commencement date), whichever is lower. The total number of shares available under the Plan is limited to 200,000 shares of common stock.

Note J / Leases

The Company leases its facilities, including sales offices, and certain equipment under various operating leases which expire through 1993. Future minimum rental payments at March 31, 1987, under agreements classified as operating and capital leases with noncancellable terms in excess of one year, are as follows:

Fiscal years ending March 31	Operating Leases	Capital Lease
1988	\$ 3,905,000	\$108,356
1989	4,041,000	108,356
1990	3,946,000	108,356
1991	2,965,000	108,356
1992	365,000	108,356
Thereafter	98,000	406,340
Total minimum lease payments	\$15,320,000	948,120
Less amount representing interest		383,209
Present value of net minimum lease payments		\$564,911

Rent expense amounted to \$3,235,900, \$1,741,900 and \$774,800 for the years ended March 31, 1987, 1986 and 1985, respectively.

Note K / Income Taxes

The provision for income taxes in the accompanying Consolidated Statement of Operations for 1986 represents income taxes paid to a foreign country in connection with revenue generated outside the United States. This amount is available as a foreign tax credit carryforward, which expires in 1991, and may be used to reduce the Company's future federal income tax liability.

As of March 31, 1987, the Company has a net operating loss carryforward for federal income tax purposes of approximately \$8,100,000; for financial statement purposes, the loss carryforward is approximately \$6,100,000. No income tax benefit for net operating losses has been recognized as of March 31, 1987. The difference between the net operating loss carryforward for federal income tax and for financial statement purposes principally represents the difference in accounting for depreciation. As of March 31, 1987, the Company has investment and research and development tax credit carryforwards of approximately \$630,000 which are available to reduce future federal income taxes payable. The net operating loss and tax credit carryforwards expire through 2002.

Note L / Major Customers

In the years ended March 31, 1986 and 1985, the Company reported revenue from a different major customer in excess of 10% of total revenues. The revenue reported from each of these major customers amounted to 11% from Canon Inc. in fiscal 1986, and 25% from Eastman Kodak Company in fiscal 1985.

Note M / Export Sales

For the years ended March 31, 1987 and 1986, revenues from foreign customers were approximately 8% and 17% of total revenues, respectively.

Note N / Other Income

In April 1985, the Company sold its equity interest in the new corporate headquarters building (see Note F) to the developer of the property. The proceeds from the sale (\$325,000) are included in other income for the year ended March 31, 1986.

Note O / Interest Income and Expense

Year ended March 31	1987	1986	1985
Interest income	\$738,320	\$ 178,421	\$ 51,338
Interest expense	(240,773)	(322,596)	(137,268)
	<u>\$497,547</u>	<u>\$(144,175)</u>	<u>\$ (85,930)</u>

On March 31, 1987, the Company entered into an arrangement with ML Technology Ventures, L.P. ("MLTV") for the funding of ongoing product development in the personal computer and international electronic publishing markets. MLTV, a research and development limited partnership sponsored by Merrill Lynch Capital Markets, will provide the Company with \$3.5 million in funding through September 1988. There can be no assurance that the research will be successful or will result in technology with any technical or commercial value. In the event, however, that the Company fails to complete the research to be performed by it for the \$3.5 million to be provided by MLTV, the Company may have to continue the research with its own funds up to a maximum of \$700,000 over the \$3.5 million.

As provided for in the Agreement, the Company purchased an option for \$378,125 to enter into a joint venture with MLTV for commercialization of these products. If the Company exercises the option, it must make an initial cash investment in the joint venture of \$25,000 and will be committed to manufacture and market the product for the joint venture and to make additional cash contributions as needed to meet the working capital needs of the joint venture. In return, the Company will receive 65% of the revenues from the sale of such products. Upon the later of the first anniversary of the commencement of the joint venture or the quarter in which the joint venture's cumulative profits allocatable to MLTV equal or exceed \$1,500,000, the Company will then have a thirty-day option to purchase all of MLTV's rights to the technology for \$5,500,000. Also in connection with the arrangement, MLTV obtained a warrant at a cost of \$378,125 to purchase 125,000 shares of the Company's stock through March 1994 at \$13.50 per share. This amount is included in additional paid-in capital at March 31, 1987.

On March 31, 1987, MLTV advanced \$600,000 to the Company as a deposit to be expended on qualified research activities. Under the terms of the agreement, research funds are advanced quarterly based upon the development plan and actual expenditures incurred. No costs have been incurred by the Company through March 31, 1987 with respect to this research and development agreement.

**Report of Independent
Auditors**

Board of Directors
Interleaf, Inc.
Cambridge, Massachusetts

We have examined the consolidated balance sheets of Interleaf, Inc. and subsidiaries as of March 31, 1987 and 1986, and the related consolidated statements of operations, changes in shareholders' equity and changes in financial position for each of the three years in the period ended March 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Interleaf, Inc. and subsidiaries at March 31, 1987 and 1986, and the consolidated results of their operations and changes in their financial position for each of the three years in the period ended March 31, 1987 in conformity with generally accepted accounting principles applied on a consistent basis, except for the change, with which we concur, in the method of accounting for computer software to be sold to customers as described in Note B to the consolidated financial statements.

Ernst & Whinney

Boston, Massachusetts
April 27, 1987

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1987 and 1986 and the market range for the Company's common stock after its initial public offering in June 1986.

Quarter ended		June 30	September 30	December 31	March 31	Year
Fiscal 1987	Revenues	\$6,404,643	\$8,577,523	\$10,404,948	\$11,786,048	\$37,173,162
	Net income (loss)	(1,154,449)	(250,682)	352,690	642,320	(410,121)
	Net income (loss) per share	(.13)	(.02)	.03	.06	(.04)
	Common stock prices					
	High	12 5/8	12 3/4	11 3/4	15	15
	Low	11	7 1/2	8 3/8	8 1/8	7 1/2
Fiscal 1986	Revenues	\$2,789,340	\$3,774,741	\$ 5,241,704	\$ 6,840,098	\$18,645,883
	Net income (loss)	(1,362,439)	(962,863)	(375,998)	257,899	(2,443,401)
	Net income (loss) per share	(.16)	(.12)	(.04)	.03	(.29)

The Company has never paid cash dividends on its common stock. The Company presently intends to retain earnings for use in its business and therefore does not anticipate paying any cash dividends in the foreseeable future.

The Company's common stock has been traded on the NASDAQ National Market System since its initial public offering in June 1986. On April 30, 1987, there were 886 holders of record of the Company's common stock.

Board of Directors

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Interleaf, Inc.

Harry A. George
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Interleaf, Inc.

George D. Potter, Jr.
Vice President of Marketing
Interleaf, Inc.

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First Capital Corp. of Chicago

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Operations

Edmund W. Grossman
Vice President of Operations

Stephen D. Pelletier
Vice President of Product
Development

Steven M. Schwartz
Vice President of Marketing
Programs and Communications

Shareholder Information*Common Stock*

Interleaf's common stock is traded over the counter on the NASDAQ National Market System – symbol LEAF.

Annual Meeting

The Annual Meeting of Shareholders will be held on August 14, 1987 at 9 a.m. at the Bank of Boston, 100 Federal Street, Boston, Massachusetts.

Form 10-K

Copies of Interleaf's Annual Report on Form 10-K are available upon request from: Investor Relations Interleaf, Inc. 10 Canal Park Cambridge, MA 02141

Transfer Agent

The First National Bank of Boston
Boston, Massachusetts

Shareholder Change of Address

You may report a change of address by sending a signed and dated letter or postcard stating you are an Interleaf shareholder, the name in which the stock is registered, and your previous and current address to:
The First National Bank of Boston
Shareholder Services Division
PO Box 644
Boston, MA 02102

Investor Relations

To receive further information about Interleaf, please contact: Investor Relations (617) 577 9800

Independent Auditors

Ernst & Whinney
Boston, Massachusetts

Legal Counsel

Hale and Dorr
Boston, Massachusetts

Corporate Directory*Headquarters*

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Cambridge, MA 02141
(617) 577 9800

*Sales Offices**United States*

Los Angeles, California
Irvine, California
San Diego, California
Santa Clara, California
San Francisco, California
Denver, Colorado
Greenwich, Connecticut
Washington, D.C.
Atlanta, Georgia
Chicago, Illinois
Baltimore, Maryland
Boston, Massachusetts
Detroit, Michigan
Minneapolis, Minnesota
St. Louis, Missouri
Iselin, New Jersey
New York, New York
Philadelphia, Pennsylvania
Houston, Texas
Dallas, Texas
Seattle, Washington

Canada

Calgary, Alberta
Vancouver, British Columbia
Toronto, Ontario
Ottawa, Ontario
Montreal, Quebec

International

Paris, France
London, England
(opening fiscal 1988)
Milan, Italy
(opening fiscal 1988)

Customers

The diversity reflected in this sampling of customers illustrates the broad utility of Interleaf's electronic publishing solutions.

Aerospace

Boeing
General Dynamics
Hughes Aircraft
McDonnell Douglas

Automotive

Chrysler
Ford Motor
General Motors

Chemicals

Monsanto
Morton Thiokol
Union Carbide

Computers

Alliant
Data General
Digital Equipment Corp.
Hewlett-Packard
Honeywell
MCC
NCR
Pitney Bowes
Unisys

Electronics

General Electric
Loral
The Singer Company
Texas Instruments
Westinghouse

Financial Services

Alex. Brown
Citicorp
Hambrecht & Quist
Lazard Frères
Moody's
Morgan Stanley
Primerica

Metal Products

Alcoa
Colt Industries

Pharmaceuticals

Wyeth Laboratories

Publishing

Houghton Mifflin
Ziff-Davis

Service Industries

Federal Express

Telecommunications

BellSouth Services
GTE
Rockwell Switching

Transportation

North American Van Lines

Government

Department of Agriculture
Department of State
Department of Transportation
Federal Reserve Board
Interstate Commerce Commission
National Oceanic & Atmospheric Administration

Universities

Brown University
Harvard University
University of Pennsylvania

About this Annual Report

This annual report was created entirely on an Interleaf electronic publishing system. Text was entered and formatted at the Interleaf keyboard. Illustrations were created from combinations of scanned photographs and graphics created on-line.