Interleaf, Inc. *Annual Report 1989*

Interleaf, Inc. develops and markets electronic publishing systems and software for business, government and academia. Interleaf allows people to create, review, revise, illustrate, store, retrieve, distribute and print documents containing text, drawings, charts, CAD images and photographs.

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Financial Highlights

Year ended March 31	1989	1988	1987
For the year			
Revenues	$82,780,181	$58,388,721	$37,173,162
Net income (loss)	863,279	6,979,897	(410,121)
At year end			
Working capital	30,809,298	26,549,588	27,190,948
Total assets	74,051,153	61,762,464	44,734,377
Total shareholders' equity	45,064,238	42,992,655	35,290,459
Number of employees	762	558	355

Interleaf's revenues for fiscal year 1989 were $82.8 million, up 42% from $58.4 million in fiscal year 1988. Net income was $863,000 ($.07 per share), compared with $5.6 million ($.47 per share) before an extraordinary credit for fiscal year 1988. Although Interleaf remained profitable throughout last year — and revenues grew substantially — we were disappointed with our bottom line.

Let me put the past year in perspective.

Profitability

Entrance into PC Market ▪ Interleaf has established itself as the clear leader in our traditional market — publishing software for engineering workstations from Apollo, Digital Equipment, IBM, Sun Microsystems and soon, Hewlett-Packard. If our only goal were to improve profitability in the short term, it would make sense for us to stick to the market we know best. Why, then, have we also chosen to enter a very different arena, the PC market?

While the workstation market is big and growing, the PC market is vastly larger. It's estimated that *five million* 386-based PCs — all able to run Interleaf software — will be sold in the next two years, as compared with the 400,000 or so workstations, which have been our primary platform, sold to date. Those five million 386's represent an enormous opportunity for Interleaf.

We are building a broad product line on PCs; the investment required is major, and did not begin to pay back as expected in fiscal year 1989. We anticipate a substantial return on that investment over the next few years.

Direct Sales ■ The outstanding effort by the U.S. direct sales force accounted for more than two-thirds of our domestic sales last year. The overall productivity of our sales force has remained excellent — on a per-person basis it performed as well this year as in fiscal year 1988. But because of promotions and management-initiated turnover, we ended the year with fewer sales representatives than we had planned. This situation has been rectified, and we are quickly coming up to plan in terms of the number of productive salespeople.

The direct sales effort is vital to our future success because, while simpler products can be moved through third parties, many of our customers have extremely sophisticated publishing environments that demand the expertise and attention of a dedicated Interleaf representative.

Lower Gross Margins ■ Gross margins on the sales of systems and software fell below those of the prior year (63% in fiscal year 1989 versus 69% in fiscal year 1988) primarily because of the increasingly competitive nature of the workstation and personal-computer hardware markets. Also, Apollo, Digital Equipment and Sun Microsystems all introduced an unprecedented number of new products in a very short time. As a result, we found ourselves with inventory nearing the end of its product life cycle. A successful inventory reduction program conducted during the last two quarters enabled the Company to sell approximately $2.2 million of this inventory, but at reduced margins.

To prevent this situation from recurring, we are now taking more of a just-in-time approach to hardware inventory. This is more feasible in the current climate — previously, workstation vendors had far longer lead times. We are also now stocking only our fastest-selling items, and, in fact, we are beginning to drop-ship some of the hardware we sell directly from the manufacturer to our customers.

It's important that our direct sales force have the flexibility to offer a variety of solutions to our customers: some choose to purchase just software from us; others prefer to purchase an entire turn-key system. Most also rely on Interleaf to supply the appropriate peripheral devices for their application. As the installed

base of workstations, 386's and Macintosh II's expands, however, we expect a continuation of the trend we have seen since we have been a public company — a gradual increase in high-margin, software-only sales as a percentage of total sales. This pattern will help us achieve our gross-margin goal of 70% by the end of fiscal year 1990.

Operating Expenses ■ Selling, general and administrative (SG&A) expense increased as a percentage of total revenues, from 44% in fiscal year 1988 to 50% in fiscal year 1989. SG&A increased primarily because of the imbalance between sales management and quota-carrying salespeople. We believe the sales management structure now in place can support a doubling of the sales force. Further, we have slowed non-sales headcount growth substantially in the last six months.

Research and development (R&D) expense, net of our R&D limited partnerships, ran at 13% of revenues compared with 12% last year. We intend to hold R&D headcount relatively flat, and our goal is to exit the year at a 14% rate without any reimbursement of R&D expenses from the limited partnerships.

Customer Enthusiasm for TPS Release 4

The most significant event of last year was shipment of Release 4 of our Technical Publishing Software. Interleaf TPS enables users to create, revise, illustrate, share, manage, store and retrieve documents. It is typically used to produce technical documentation, proposals, reports, plans, presentations, data sheets, catalogs, forms, price books — literally the full range of publications produced by corporations, government agencies and academic institutions.

TPS 4 is sold in modules; the basic package, TPS CorePlus, provides word processing, graphics and page layout. Customers can choose among an array of add-on packages, including software for tables creation, equations, photographic image editing, advanced graphics and document management.

Release 4 contains significant technological enhancements over the previous release. TPS 3 provided superior tools for creating and illustrating documents; Release 4 extends that functionality to include tools for managing the entire document-creation process. Interleaf TPS 4 also addresses customers' needs for typographically sophisticated output and automatic separation of spot color.

Document Management ■ One of TPS 4's most powerful document-management features is the book catalog, which enables document style and content to be controlled from a single location. The U.S. Census Bureau's Electronic Graphics Section in Washington, DC, is using book catalogs to assemble new report covers from existing material. "By tagging certain text and graphics elements, we can create 50 report covers in just minutes," says Section Chief Dave Coontz.

Effectivity ■ Effectivity provides the ability to create several different renditions of a document from a master file. "Companies can leverage their development costs and shorten time-to-market by spinning off versions of existing products," says Carolyn Strong, Lab Instruments Documentation Manager at Tektronix, Inc. in Beaverton, Oregon. "TPS 4 lets us produce new manuals more easily because we can use effectivity to create up to four versions of a book from a single source." Contel Federal Systems in Fairfax, Virginia, uses effectivity in the production of standards and procedures manuals for software engineering. "We are developing standards to support two languages, Ada and C," says Chuck Williams, Senior Engineer. "Effectivity lets us automatically compose and print the correct version for the language required and saves disk space by eliminating the need to keep two separate versions on-line."

Tables ■ Interleaf's new tables package lets users create multi-page tables that grow dynamically as they are edited. The Electronic Publishing group at Briggs & Stratton Corp. in Milwaukee, Wisconsin, publishes specifications catalogs in tabular form for all Briggs & Stratton engines. "Production used to take 400 hours for these catalogs," says Debbie Pavletich, Electronic Publishing Coordinator. "Now we tag ASCII data stored on our mainframe. When it's downloaded to Interleaf, it's automatically put into table format, complete with rules and running heads. Production time has been cut 75%."

Typographic Enhancements ■ For customers requiring the highest-quality typographic output, Interleaf TPS 4 provides full pair and track kerning — the ability to adjust the space between characters — as well as expanded type libraries. The Graphics Services Department at Rockwell International in Richardson, Texas, is in the process of adding 51 Adobe font families to their two Linotronic typesetters. "Our Interleaf system replaced a traditional typesetting front-end," says Joe Messenger, Systems Analyst. "The new typographic functionality in Release 4 enables us to produce commercial documentation on Interleaf as well as technical publications."

Interfaces ■ With Release 4, Interleaf further extends available input and output options. Tim O'Neill, Supervisor, Technical Publications, at Kohler Company, Kohler, Wisconsin, describes how they transfer files: "First, we send a drawing generated on our Calma system to a 2-D package where engineers can edit it to remove hidden lines. Then we send it through an IGES filter to Interleaf." At Contel, Interleaf is used to integrate materials produced with other off-the-shelf software packages, such as Cadre's Teamwork. Since Cadre has developed a direct interface to Interleaf, there's no need to filter the files.

LISP ■ TPS 4 features a new desktop command language that uses LISP to enable customization of the commands that display on pop-up menus. At Tektronix, LISP scripts automate such functions as running archiving routines. Texas Instruments in Dallas, Texas, utilizes LISP to develop applications. "LISP is used to provide Interleaf users with an interface to automation programs, such as 'read a database and compose a document,'" says Cliff Whitmore, Documentation Systems Development Manager. "This helps our engineers automate the process of building software and integrated circuit technical documentation." The "LISPification" of Interleaf — the process of opening it up by making it user-programmable — will provide much of the foundation of TPS Release 5.

New Products

PCEditor and PCViewstation ■ Fiscal year 1989 saw our first volume shipments of PCEditor and PCViewstation. PCEditor provides a low-cost, TPS-compatible text processor that runs on inexpensive PCs, making it the ideal tool for entering text in an Interleaf publishing environment. Viewstation is software that also runs on standard PCs, providing a low-cost way to disseminate documents electronically throughout a corporation.

CD ROM, RDM ■ At the Seybold seminar in March 1989 we demonstrated new technology directed toward customers, such as aerospace and pharmaceutical companies, who must store and distribute vast libraries of documents. This software takes advantage of CD ROM (compact disk read-only memory) technology and will enable companies to store thousands of pages of text and graphics on a single compact disc. Interleaf's Systems Integration group is also developing a Relational Document Manager (RDM) that helps users keep track of the data, software, hardware and people that make up their publishing operation by applying the benefits of manufacturing and inventory-control technologies.

CALS ■ We also demonstrated a new product targeted to U.S. government defense contractors, who by 1990 must comply with a Department of Defense initiative known as CALS (Computer-aided Acquisition Logistic and Support program). The purpose of CALS is to enable the Defense Department to manage more efficiently the huge amounts of printed information associated with weapons systems.

The CALS Preparedness Package is a combination of software, training and support designed to help users set up their own CALS environment and gain hands-on experience with the CALS interchange formats. Interleaf has taken a leadership role in this emerging market, with members of our technical staff serving on the committees working to formulate the final CALS standards.

Mainframe Products ■ Interleaf's first mainframe product, software for demand printing from mainframe servers, was shipped to several alpha sites last year. We are getting constructive feedback from these customers, which allows us to enhance and expand the product definition, and provides useful information on the best ways to approach the mainframe market.

Peripherals ■ No Interleaf publishing system is an island, and being able to import text and graphics and print to a wide variety of industry-standard output devices is becoming increasingly important. Last year, Interleaf made progress in opening up its publishing environment to an ever-widening array of scanners, laser printers and typesetters, making it more attractive for people who already own these devices to buy our software.

On the input side, our TPS software now accepts CAD files in the most popular formats, including HPGL, IGES and CalComp. Any scanned image in TIFF format can be placed in an Interleaf document and then edited. For output, we support a host of laser printers, including many PostScript and Xerox InterPress printers in addition to our own RIPrint laser printers. For highest-resolution output, TPS supports typesetters from Autologic, Compugraphic, III, Linotype and Monotype. We will continue to expand our support for industry input and output standards in 1990.

New Directions

Customer Support ■ Interleaf's goal is to be the industry leader, not just in technology, but also in service. In addition to expanding Interleaf customer support domestically, we opened a support center in the Netherlands, dedicated to serving our European installed base. We will soon open a similar operation in California to support customers on the Pacific Rim. At our Cambridge headquarters, we will be bringing on-line a state-of-the-art customer support database.

Partners Program Established ■ To expand the definition of the "publishing" market, the Company has established a Partners in Publishing program to form marketing and technology alliances with the leaders in various market segments. For example, a major supplier of computer-aided software engineering packages is one of our publishing partners; our two packages are closely integrated so we can leverage each other's sales. To date there are nearly 50 such partners in the program, with more to come in fiscal year 1990.

International Growth

Interleaf has the opportunity to become the leading provider of multi-lingual publishing solutions overseas, and we have been expanding our international operations aggressively to meet the needs of this market. With the foreign language versions of TPS 4, which began shipping this past year, we now have a product that can produce documents in 13 languages. We anticipate that 25% of our revenues will come from foreign sales in fiscal year 1990.

Interleaf now has subsidiaries or exclusive distributors in Canada, France, the United Kingdom, Belgium, Germany, Switzerland, Italy, Sweden and Asia/Pacific. We expect to bring Australia on board this year, and we recently entered into a third-party arrangement to develop markets in South America.

In Canada, which is now adding about $1.5 million (U.S.) in revenues per quarter, Interleaf is used at many corporations, as well as throughout the Canadian federal government, including the Ministries of Labour and Health and the Departments of Public Works, External Affairs, and Fisheries and Oceans.

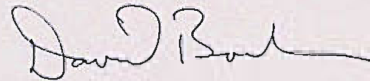
Interleaf customers in Europe include Lloyd's Bank, the European Space Agency, British Telecom, BMW, L'Aérospatiale, the U.K. Admiralty Research Establishment, the Deutsche Bundespost, Oxford University and the London Stock Exchange.

Summary

Demand for Interleaf products is excellent, and the electronic publishing market is expanding rapidly. Our products are technologically advanced, yet flexible, so they can easily be targeted to meet the needs of specific markets. We are confident that we have the best direct sales force in the electronic publishing business and a strong and expanding international presence. And in the PC arena, we have a strategic partnership with IBM — the largest, most important force in that market.

We have grown to annual gross revenues of $83 million in a very short time — in 1989 Interleaf was included on both the *Inc.* and *Venture* lists of the fastest-growing U.S. companies.

Our challenge for fiscal year 1990 is to translate this rapid growth into improved earnings.



David A. Boucher

President

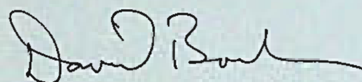
June 1989

Report of Management

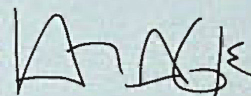
The management of Interleaf, Inc. and its subsidiaries is responsible for preparing the accompanying financial statements and for ensuring their integrity. The statements were prepared in accordance with generally accepted accounting principles. In instances where exact measurement is not possible, the financial statements include amounts that are based on management's best estimates and judgments. Management also prepared the other financial information in this Annual Report and is responsible for its accuracy and consistency with the financial statements.

In meeting its responsibility for the Company's consolidated financial statements, management maintains a system of internal accounting control, which is reviewed and evaluated on a regular basis. This system is designed to provide reasonable assurance that assets are safeguarded and that transactions are properly recorded and executed in accordance with management's authorization. However, there are inherent limitations that should be recognized in considering the assurances provided by any system of internal accounting control. The concept of reasonable assurance recognizes that the costs of a system of internal accounting control should not exceed the benefits to be derived.

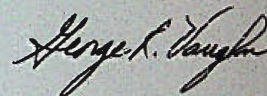
The consolidated financial statements of Interleaf, Inc. and its subsidiaries have been audited by Ernst & Whinney, independent auditors, whose report is contained herein. Their audit includes an evaluation of the Company's accounting systems and internal controls, as well as performance of other auditing procedures to reasonably ensure that the consolidated financial statements are fairly presented.



David A. Boucher
Chairman, President and
Chief Executive Officer



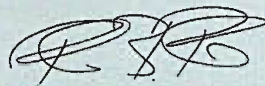
Harry A. George
Vice President of Finance and
Chief Financial Officer



George R. Vaughn
Controller and
Principal Accounting Officer

Report of Audit Committee Chairman

The Audit Committee of the Board of Directors is composed of two independent directors. The Committee held three meetings during fiscal 1989. The Committee oversees the Company's financial reporting process on behalf of the Board of Directors. In fulfilling its responsibility, the Committee recommended to the Board of Directors the appointment of Ernst & Whinney as the Company's independent auditors. The Committee discussed with Ernst & Whinney the overall scope and specific plans for their audit and the adequacy of the Company's internal controls. The Committee met with Ernst & Whinney, without management present, to discuss the results of their audit, their evaluation of the Company's internal controls, and the overall quality of the Company's financial reporting. Meetings during the year were also designed to encourage confidential discussions as to any auditing matters.



Frederick B. Bamber
Chairman, Audit Committee

Management's Discussion and Analysis of Financial Condition and Results of Operations

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, 1989, as a percentage of revenues:

Year ended March 31	1989	1988	1987
Revenues	100%	100%	100%
Costs and expenses:			
Cost of products sold	26	23	35
Cost of services sold	8	8	9
Selling, general and administrative	50	44	43
Research and development	13	12	15
Total operating costs and expenses	97	87	102
Income (loss) from operations	3	13	(2)
Interest income (expense), net	(1)	1	1
Income (loss) before income taxes	2	14	(1)
Provision for income taxes	1	4	–
Income (loss) before extraordinary credit	1	10	(1)
Extraordinary credit	–	2	–
Net income (loss)	1%	12%	(1%)

Revenues Total revenues for the years ended March 31, 1987, 1988 and 1989, were $37,200,000, $58,400,000 and $82,800,000, respectively. The annual increases in the Company's revenues have been generated primarily from the expansion of the Company's domestic and foreign sales operations resulting in increased unit sales as well as increased service revenues reflecting the growing installed base of customers. Sales of systems and software increased $15,200,000 (34%) from 1988 to 1989 and $13,600,000 (45%) from 1987 to 1988. Software-only sales, as a component of the system and software sales amounts, increased at a much more rapid pace, 52% from 1988 to 1989 and 293% from 1987 to 1988. The Company anticipates a continued increase in the growth of higher-margin software sales as a percentage of total revenues because of the increasing installed base of compatible hardware provided by hardware manufacturers. This total revenue growth illustrates the increased acceptance of the Company's products in the computer-aided publishing marketplace and the growing availability and installation of computer hardware being shipped by original equipment manufacturers (OEMs) on which the Company's publishing software operates. Planned additions to the Company's sales force are expected to generate additional sales volume during the coming year. The Company expects that the rate of growth in annual revenues for fiscal year 1990 will be comparable to the growth rate experienced during the last year.

Service revenues increased $5,200,000 (83%) from 1988 to 1989 and $3,700,000 (142%) from 1987 to 1988. These increases reflect the growing installed base of customers, most of which now purchase maintenance contracts from the Company. In addition, during the past two years, the Company was able to enter into maintenance contracts with a

greater proportion of its pre-existing installed base of customers. These contracts provide for computer hardware servicing, if the equipment was purchased from the Company, and software support in the form of telephone assistance and periodic upgrades to the application software. The Company also offers hardware maintenance services on a time-and-materials basis to customers that have not purchased hardware maintenance contracts from the Company. Revenue from such services represented less than 8% of service revenues for 1989, 1988 and 1987. Since the pre-existing customer base has already been substantially captured during the past two years, service revenues are not expected to increase at as rapid a pace as was previously experienced.

Software license and royalty revenues increased $1,800,000 (25%) from 1988 to 1989 and $3,700,000 (111%) from 1987 to 1988. These revenues are derived from a number of different relationships — third-party royalties, porting fees and revenues from distribution rights. Revenues from these relationships often represent unique, non-recurring opportunities for the Company. As such, it is difficult to predict the amount of future revenues that may be derived from similar opportunities. In the Company's ongoing efforts to achieve worldwide market penetration and distribution, the Company anticipates entering into similar arrangements in the future.

Other income increased $2,200,000 (216%) from 1988 to 1989 and $292,000 (39%) from 1987 to 1988 primarily due to increases in training revenue and sales of user manuals, both reflecting the increase in number of software licenses.

The Company generally manufactures its software and systems on the basis of its forecast of near-term demand and generally ships to end users within 30 days after receipt of an order. The Company's backlog is therefore not indicative of future sales levels. A high percentage of the Company's shipments occur in the last month of each fiscal quarter, which is common in the computer industry. Therefore, significant fluctuations in revenues and net income could potentially occur from quarter to quarter based upon the timing of orders and shipments.

Cost of Products Sold Cost of products sold increased $8,400,000 (62%) from 1988 to 1989 and $425,000 (3%) from 1987 to 1988. As a percentage of systems and software revenue, these costs represented 37%, 31% and 43% for 1989, 1988 and 1987, respectively. During the third and fourth quarters of 1989 the Company sold approximately $2,200,000 of hardware inventory at reduced gross margins as part of an inventory reduction program. In addition, the Company experienced lower overall margins on systems sales as a whole due to the increasingly competitive nature of the workstation and personal-computer hardware markets. These lower margins more than offset the growth in software-only sales, which have a nominal cost-of-goods-sold component. Due to the completion of the inventory reduction program, margins on hardware sales are expected to slightly increase. The blended gross margin, including software-only sales, is also expected to increase as total revenues become weighted more towards software-only sales.

Cost of Services Sold Cost of services sold increased $2,400,000 (55%) from 1988 to 1989 and $1,100,000 (33%) from 1987 to 1988, but decreased as a percentage of service revenues from 126% in 1987 to 69% in 1988 and 59% in 1989. Revenues from the growing installed base of customers increased at a more rapid pace than did expenses during this three-year period despite increases in the number of support personnel, facilities costs and supporting supplies and materials to accommodate the increased user population. Service costs are expected to continue to increase primarily due to personnel additions necessary to service the growing installed base of software licenses.

Selling, General and Administrative Selling, general and administrative expenses increased $15,100,000 (58%) from 1988 to 1989 and $9,700,000 (60%) from 1987 to 1988, representing 50% of total revenues in 1989, 44% in 1988 and 43% in 1987. The increase in these costs as a percentage of revenues in 1989 occurred principally during the first two quarters of the year as the Company continued to build an organization to support anticipated higher revenue levels.

These sales levels were not achieved and therefore these costs represented a higher percentage of the lower actual level of revenues. The increase in actual dollars over the three-year period reflects personnel increases and related costs necessitated by the 42% increase in total revenues from 1988 to 1989 (57% increase in revenues from 1987 to 1988). The Company's sales operations in Canada and the United Kingdom contributed both revenue and expenses for all of 1989, but for only part of 1988, while the Company's newly opened operation in Sweden incurred expenses but provided virtually no revenue during 1989.

Research and Development Research and development expenses, net of R&D limited partnerships, increased $3,600,000 (51%) from 1988 to 1989 and $1,500,000 (27%) from 1987 to 1988, representing 13% of total revenues in 1989, 12% in 1988 and 15% in 1987. The Company is committed to a high level of research and development expenses and the increase in such expenses during the three-year period is primarily attributable to increases in personnel as new products and enhancements to existing products were developed and introduced to the marketplace. Increases in facilities and depreciation expenses, both related to the growth in personnel engaged in research and development, were also experienced. The Company's software runs on a wide variety of workstations and personal computers requiring significant investments in personnel and equipment to maintain a technological leadership position. Future levels of annual expenses are expected to exceed those of prior years but, as a percentage of total revenues, are expected to remain at approximately the same level as in 1989.

Interest Income and Expense For most of 1989 the Company borrowed under the revolving credit arrangement described in Note E, resulting in interest expense exceeding interest income by $980,000 for the year. Net interest income generated in both 1988 and 1987 was derived principally 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 At March 31, 1989, the Company had working capital of $30,800,000, an increase of $4,300,000 over the $26,500,000 level at March 31, 1988. However, during most of 1989 the Company was in a net borrowing position and at March 31, 1989, had $9,400,000 outstanding under the revolving credit arrangement described in Note E. The decline in cash was primarily due to significant investments in capital equipment ($9,700,000) necessitated by the addition of 204 employees during 1989 and the financing of accounts receivable and other current assets pertaining to the 42% increase in revenues from 1988. The Company believes that as revenues grow, cash requirements to finance accounts receivable and other assets will continue to increase.

The Company anticipates acquiring the equity interest it does not currently own in Interleaf France S.A. on or before December 31, 1989, for approximately $7,000,000. Currently, the Company owns 20% of the equity in Interleaf France. During the first six months of fiscal 1991, the Company expects that operations and the general business climate of the personal-computer market will render it appropriate to purchase all of MLTV's rights to certain technology described in Note L. This will require a $5,500,000 payment projected to be made during either the first or second quarter of fiscal 1991. The Company continues to review joint venture relationships concerning operations in Germany, Italy and Asia as well as with PruTech (see Note L) to determine when, if ever, the appropriate time would be to acquire all or additional interests in these ventures.

During fiscal 1990, the Company expects to explore public and/or private debt or equity financing alternatives to meet its anticipated liquidity needs.

Consolidated Statements of Operations

Year ended March 31	1989	1988	1987
Revenues			
Sales of systems and software	$59,345,599	$44,157,223	$30,552,772
Service revenues	11,436,644	6,239,726	2,581,074
Software license and royalty revenues	8,699,043	6,947,197	3,287,079
Other income	3,298,895	1,044,575	752,237
	82,780,181	58,388,721	37,173,162
Costs and expenses			
Cost of products sold	21,841,577	13,481,393	13,056,380
Cost of services sold	6,723,070	4,326,786	3,244,447
Selling, general and administrative	41,026,319	25,924,195	16,194,369
Research and development	10,677,719	7,071,235	5,585,634
Total operating costs and expenses	80,268,685	50,803,609	38,080,830
Income (loss) from operations	2,511,496	7,585,112	(907,668)
Interest expense	(1,254,879)	(366,431)	(240,773)
Interest income	271,662	611,216	738,320
Income (loss) before income taxes	1,528,279	7,829,897	(410,121)
Provision for income taxes	665,000	2,261,000	–
Income (loss) before extraordinary credit	863,279	5,568,897	(410,121)
Extraordinary credit:			
Benefit from utilization of net operating loss carryforward	–	1,411,000	–
Net income (loss)	$ 863,279	$ 6,979,897	$ (410,121)
Earnings (loss) per share			
Income (loss) before extraordinary credit	$.07	$.47	$(.04)
Extraordinary credit	–	.12	–
Net income (loss) per share	$.07	$.59	$(.04)
Shares used in computing net income (loss) per share	11,895,401	11,833,391	10,507,891

See notes to consolidated financial statements.

Consolidated Balance Sheets

Assets

March 31	1989	1988
Current assets		
Cash and cash equivalents	$ 3,498,113	$10,299,807
Accounts and royalties receivable, net of allowance for doubtful accounts of $598,000 and $440,000, respectively	27,620,821	17,241,899
Inventories	11,595,477	11,355,630
Prepaid expenses and other current assets	3,048,751	840,845
Total current assets	45,763,162	39,738,181
Property and equipment, net	18,193,682	13,723,562
Other assets	5,370,678	3,146,567
Excess of purchase price over net assets of business acquired	4,723,631	5,154,154
	$74,051,153	$61,762,464

Liabilities and shareholders' equity

	1989	1988
Current liabilities		
Accounts payable	$ 6,755,275	$ 5,494,848
Accrued expenses	2,563,703	2,535,645
Accrued compensation and related items	2,539,392	2,363,897
Unearned service revenues	1,749,882	1,435,892
Current portion of long-term debt	1,202,604	1,316,100
Current portion of capital lease obligations	143,008	42,211
Total current liabilities	14,953,864	13,188,593
Long-term debt, less current portion	12,524,700	4,327,322
Capital lease obligations, less current portion	721,681	485,617
Deferred taxes	733,000	536,000
Unearned revenue	53,670	232,277
Shareholders' equity		
Preferred stock, par value $.10 per share, authorized 5,000,000 shares, none issued and outstanding		
Common stock, par value $.01 per share, authorized 20,000,000 shares, issued and outstanding 11,526,383 shares (11,358,837 shares in 1988)	115,264	113,588
Additional paid-in capital	43,338,753	42,143,441
Retained earnings	1,540,390	677,111
Equity adjustment for foreign currency translation	69,831	58,515
	45,064,238	42,992,655
	$74,051,153	$61,762,464

See notes to consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity

	Convertible Preferred Stock Series C	Series D	Series E	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Equity Adjustment	Total Shareholders' Equity
Balances at April 1, 1986	$ 177,778	$92,109	$ 150,184	$ 42,607	$16,450,238	$(5,892,665)	–	$11,020,251
Conversion of Convertible Preferred Stock into common stock	(177,778)	(92,109)	(150,184)	42,007	378,064	–	–	–
Net proceeds from sale of 2,650,000 shares of common stock in initial public offering	–	–	–	26,500	24,117,011	–	–	24,143,511
Common stock issued in connection with incentive stock options exercised by employees	–	–	–	971	157,722	–	–	158,693
Proceeds from sale of warrant	–	–	–	–	378,125	–	–	378,125
Net loss	–	–	–	–	–	(410,121)	–	(410,121)
Balances at March 31, 1987	–	–	–	112,085	41,481,160	(6,302,786)	–	35,290,459
Common stock issued in connection with incentive stock options exercised by employees	–	–	–	1,291	398,718	–	–	400,009
Common stock issued in connection with employee stock purchase plan	–	–	–	212	263,563	–	–	263,775
Equity adjustment for foreign currency translation	–	–	–	–	–	–	$58,515	58,515
Net income	–	–	–	–	–	6,979,897	–	6,979,897
Balances at March 31, 1988	–	–	–	113,588	42,143,441	677,111	58,515	42,992,655
Common stock issued in connection with incentive stock options exercised by employees	–	–	–	876	310,600	–	–	311,476
Common stock issued in connection with employee stock purchase plan	–	–	–	800	704,712	–	–	705,512
Proceeds from sale of warrant	–	–	–	–	180,000	–	–	180,000
Equity adjustment for foreign currency translation	–	–	–	–	–	–	11,316	11,316
Net income	–	–	–	–	–	863,279	–	863,279
Balances at March 31, 1989	–	–	–	$115,264	$43,338,753	$ 1,540,390	$69,831	$45,064,238

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Year ended March 31	1989	1988	1987
Operating activities			
Net income (loss)	$ 863,279	$ 6,979,897	$ (410,121)
Adjustments to reconcile net income (loss) to net cash from (used in) operating activities:			
Depreciation and amortization	6,627,240	4,071,928	1,990,084
Provision for losses on accounts receivable	157,329	15,000	365,000
Provision for deferred taxes	201,560	536,000	–
Increase in unearned revenue	143,358	690,527	347,777
Changes in operating assets and liabilities:			
Increase in accounts and royalties receivable	(10,620,694)	(6,396,254)	(5,516,849)
Increase in inventories	(243,840)	(2,862,754)	(2,720,031)
(Increase) decrease in prepaid expenses and other current assets	(1,498,545)	679,726	(2,116,544)
Increase in accounts payable, accrued expenses and accrued compensation	1,587,423	2,648,306	1,985,695
Foreign currency transaction gain	11,699	62,399	–
Net cash from (used in) operating activities	(2,771,191)	6,424,775	(6,074,989)
Investing activities			
Additions to property and equipment, net	(9,715,645)	(8,517,372)	(5,252,143)
Capitalized software development costs	(2,515,000)	(1,647,000)	(747,000)
Increase in other assets	(948,930)	(944,472)	(425,271)
Payments for acquisition, net of cash acquired	(500,000)	(5,264,152)	–
Net cash used in investing activities	(13,679,575)	(16,372,996)	(6,424,414)
Financing activities			
Net proceeds from sale of common stock in initial public offering	–	–	24,143,511
Net proceeds from sale of common stock	1,016,988	663,784	158,693
Proceeds from sale of warrant	180,000	–	378,125
Proceeds from long-term debt	12,865,538	5,112,800	–
Decrease in long-term debt and capital lease obligations	(4,427,490)	(842,381)	(546,190)
Net cash provided from financing activities	9,635,036	4,934,203	24,134,139
Effect of exchange-rate changes on cash	14,036	24,988	–
Net increase (decrease) in cash and cash equivalents	(6,801,694)	(4,989,030)	11,634,736
Cash and cash equivalents at beginning of year	10,299,807	15,288,837	3,654,101
Cash and cash equivalents at end of year	$ 3,498,113	$ 10,299,807	$15,288,837

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.

Foreign Currency Translation The translation of assets and liabilities of foreign subsidiaries is made at year-end rates of exchange, and revenue and expense accounts are recorded at average rates of exchange. The resulting translation adjustments are excluded from net income and are accumulated as a separate component of shareholders' equity. Transaction gains and losses were not material.

Affiliates The Company's 20% investment in Interleaf France S.A. and 39% investment in Interleaf Italia S.r.l., corporate joint ventures, are accounted for on the equity basis. Under certain conditions, the Company has the option and may be required to purchase the remaining interest in Interleaf France S.A. at a minimum of approximately $3 million and a maximum of approximately $7 million based upon operating results. Results of operations for these entities through March 31, 1989, are not material.

Revenue Recognition Revenues from the sale of systems and software are recognized at the time of shipment. Contractual service revenues are recognized ratably over the contract period, which is 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 that have not been earned are classified as unearned revenue.

Cash Equivalents Cash equivalents represent short-term investments with maturities of generally three months or less.

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.

Property and Equipment Property and equipment 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.

Intangible Assets The excess of purchase price over net assets of an acquired business is amortized over a 25-year period.

Income Taxes The Company provides for income taxes actually payable and for deferred taxes related to temporary differences between financial and taxable income. Investment and other tax credits are accounted for under the "flow-through" method.

Earnings (Loss) Per Share Earnings (loss) per share is based on the weighted average number of common shares and dilutive common stock equivalents outstanding during the year adjusted to reflect the conversion of all outstanding shares of preferred stock into common stock. Common stock equivalents are attributable to stock options and common stock warrants.

Basis of Presentation Certain 1988 and 1987 amounts have been reclassified to conform to the 1989 method of presentation.

Note B Inventories

Inventories at March 31, 1989 and 1988, consist of the following:

	1989	1988
Finished goods and work-in-process	$ 3,227,636	$ 3,714,813
Raw materials	4,173,789	4,508,347
Field service	4,194,052	3,132,470
	$11,595,477	$11,355,630

Note C Capitalized Software 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. For the years ended March 31, 1989, 1988 and 1987, the Company capitalized $2,515,000, $1,647,000 and $747,000, respectively, of software production costs, of which $1,147,000 ($473,000 in 1988 and $90,000 in 1987) was amortized and charged to expense and $3,199,000 is included in other assets at March 31, 1989 ($1,831,000 at March 31, 1988).

Note D Property and Equipment

Property and equipment at March 31, 1989 and 1988, consist of the following:

	1989	1988
Office equipment	$ 8,782,362	$ 5,639,629
Demonstration equipment	6,402,359	3,511,676
Development equipment	6,756,064	5,095,269
Furniture	3,786,314	2,525,674
Leasehold improvements	3,463,038	2,852,243
Building	846,007	843,408
	30,036,144	20,467,899
Less allowances for depreciation and amortization	11,842,462	6,744,337
	$18,193,682	$13,723,562

Note E Credit Arrangements

The Company has a committed, revolving line of bank credit of $20,000,000 which is unsecured and bears interest at prime rate plus 1/4%. Under the terms of this credit, the Company may borrow up to the lesser of $20,000,000 or a borrowing base amount consisting of 80% of qualified accounts receivable plus 40% (up to a maximum of the lesser of $2,000,000 or 20% of the accounts receivable portion) of inventory. A commitment fee of 3/8% of the amount of unused credit is charged quarterly. The Company is required to pay any borrowings under this revolving credit commencing December 31, 1991, in equal quarterly installments through September 30, 1993, with interest at prime rate plus 1/2%. The Company may, however, pay the total amount outstanding at any time without penalty. The credit agreement includes certain operating covenants relating to the Company's current ratio, tangible net worth and to the achievement of profitable operations as well as restrictions on the payment of dividends.

Note F Long-term Debt

Long-term debt at March 31, 1989 and 1988, is as follows:

	1989	1988
Loan payable under revolving credit agreement	$ 9,400,000	–
Loan payable in monthly principal installments of $41,667 plus interest at prime rate plus 1/2%	1,875,000	$2,375,000
Loan payable in monthly principal installments of $30,000 plus interest at prime rate plus 1/2%	1,260,000	1,620,000
Loan payable with principal due November 1990, with interest payable quarterly at 15.1438%	812,800	812,800
Loan payable in monthly principal installments of $18,765 plus interest at prime rate plus 3/4%	206,422	431,602
Loan payable in monthly principal installments of $9,225 plus interest at prime rate plus 3/4%	147,582	258,282
Loan payable in monthly principal installments of $8,500 plus interest at prime rate plus 1 1/4%	25,500	127,500
Commercial note payable in monthly principal installments of $3,646 with interest at prime rate plus 1 1/2%	–	18,238
	13,727,304	5,643,422
Less current portion	1,202,604	1,316,100
	$12,524,700	$4,327,322

Building and equipment with a net book value at March 31, 1989, of approximately $2,658,000 is pledged as collateral for all long-term debt except the revolving credit agreement.

Maturities of long-term debt during each of the next five fiscal years are as follows: 1990 – $1,202,604; 1991 – $1,709,700; 1992 – $3,210,000; 1993 – $5,255,000; 1994 – $2,350,000.

Interest paid approximated interest expense in each of the three years in the period ended March 31, 1989.

Note G Shareholders' Equity

On June 26, 1986, the Company completed its initial public offering of common stock, selling 2,650,000 shares (including the underwriters' overallotment 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, 1989, there remained reserved 1,915,060 shares of common stock for issuance under the stock option plans described in Note H, 400,000 shares of common stock for the exercise of the stock purchase warrants described in Note L, and 98,740 shares of common stock for issuance under the Employee Stock Purchase Plan described in Note H.

On July 15, 1988, the Company declared a dividend distribution of one Preferred Stock Purchase Right (a "Right") for each outstanding share of the Company's common stock to stockholders of record on July 25, 1988. Each Right entitles the holder to purchase a unit consisting of one-hundredth of a share (a "Unit") of Series A Junior Participating Preferred Stock, $.10 par value (the "Preferred Stock"), at a purchase price of $65.00 in cash. The Rights initially trade with the shares of common stock and are not exercisable. The Rights will separate from the common stock and become exercisable 10 days after a public announcement that a person or group (an "Acquiring Person") acquires beneficial ownership of 20% or more of the outstanding shares of common stock or 10 business days after commencement of a tender offer that would result in a person or group beneficially owning 30% or more of the outstanding shares of common stock. In the event that the Company is the surviving corporation in a merger with an Acquiring Person, the acquisition of 25% of common stock by any person (except pursuant to a tender offer for all shares of common stock determined to be fair by certain directors of the Company), or upon certain self-dealing transactions or increases in an Acquiring Person's ownership of common stock, each holder of an outstanding Right other than an Acquiring Person will receive, upon exercise of a Right, the number of shares of the Company's common stock that equals the exercise price of the Right divided by one half of the current market price of the Company's common stock. In the event the Company is not the surviving corporation in a merger or more than 50% of its assets or earning power is sold or transferred after any person has become an Acquiring Person, each holder of an outstanding Right (other than any Acquiring Person) will receive, upon exercise of a Right, the number of shares of common stock of the acquiring company that equals the exercise price of the Right divided by one half of the current market price of the acquiring company's common stock. The Rights are nonvoting, expire in 10 years and may be redeemed at any time prior to becoming exercisable at a price of $.01 per Right.

Note H Stock Option and Stock Purchase Plans

The Company has established the 1983 Stock Option Plan, under the terms of which options to purchase shares of common stock at prices not less than fair market value at date of grant may be granted to key employees. The options are exercisable in whole or in part at any time prior to expiration. The options expire after 10 years from date of grant. Options remain subject to vesting provisions and buyback provisions by the Company in the event of voluntary or involuntary termination of the employee. Options are nontransferable other than on death. At the 1987 annual meeting of shareholders, the Plan was amended to provide for the automatic grant of nonstatutory stock options to all current outside directors and to outside directors who are elected in the future. At March 31, 1989, options for 424,381 shares were exercisable, and options for 214,367 shares were available for future grants.

Note H Stock Option and Stock Purchase Plans Continued

A summary of activity in the Plan is presented below:

	Number of Shares	Price of Shares
Outstanding at April 1, 1987	780,518	$ .57 - $12.00
Granted	549,850	13.50 - 20.50
Exercised	(129,082)	.57 - 11.38
Canceled	(41,514)	1.13 - 20.50
Outstanding at March 31, 1988	1,159,772	.57 - 20.50
Granted	1,291,540	7.38 - 15.63
Exercised	(87,508)	.57 - 14.63
Canceled	(813,111)	1.13 - 19.38
Outstanding at March 31, 1989	1,550,693	$ .57 - $19.38

During fiscal 1989, the Board of Directors, subject to shareholder approval, approved the cancellation and reissuance of certain stock options, at the election of the employee, that had been granted to employees during the period July 18, 1986, through August 23, 1988. This transaction resulted in the cancellation of 537,950 options at prices ranging from $10.00 to $20.50 per share and the issuance of 549,950 options at prices ranging from $7.38 to $8.38 per share, which represented the fair market value of the Company's stock on the date of exchange. Options canceled and then reissued at that date began a new vesting period of the same duration as the original grant.

In March 1989, the Board of Directors, subject to shareholder approval, adopted the 1989 Director Stock Option Plan. Under the terms of this Plan, 150,000 shares of common stock are to be reserved for the issuance of options to non-employee directors. Each current non-employee director received an option covering 12,000 shares, vesting over three years, at the fair market value on the date of grant, $8.13. Contingent upon this Plan's obtaining shareholder approval, each non-employee director surrendered his outstanding option covering 4,500 shares that were issued under the 1983 Stock Option Plan.

During fiscal 1987, the Company adopted, with 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 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, of which 21,221, 36,383 and 43,656 shares were issued in connection with the first three offerings completed on November 6, 1987; May 6, 1988 and November 4, 1988, respectively. In May 1989, the Board of Directors, subject to shareholder approval, reserved an additional 400,000 shares for issuance under the Plan, and extended the term of the Plan for an additional two years.

Note I Leases

The Company leases its facilities, including sales offices, and certain equipment under various operating leases, which expire through 1995. Future minimum rental payments at March 31, 1989, 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 Leases
1990	$ 7,988,000	$ 252,000
1991	6,941,000	257,000
1992	4,115,000	255,000
1993	3,384,000	137,000
1994	471,000	117,000
Thereafter	15,000	190,000
Total minimum lease payments	$22,914,000	1,208,000
Less amount representing interest		343,311
Present value of net minimum lease payments		$ 864,689

Rent expense amounted to $8,077,000, $4,642,000 and $3,235,900 for the years ended March 31, 1989, 1988 and 1987, respectively.

Note J Income Taxes

The Company adopted the provisions of Financial Accounting Standards Board Statement Number 96 *Accounting for Income Taxes* as of April 1, 1988. Prior year financial statements were not restated to conform with the new standard. The cumulative effect to April 1, 1988 of the accounting change and the effect on quarterly results reported during fiscal 1989 was determined to be immaterial.

The provision for income taxes is comprised of the following:

	1989	1988
Current:		
Federal	$235,000	$1,288,000
State	68,000	367,000
Foreign	165,000	70,000
Total current	468,000	1,725,000
Deferred, principally federal	197,000	536,000
	$ 665,000	$2,261,000

Note J Income Taxes Continued

The provision for income taxes is based on the following amounts of income before income taxes:

	1989	1988
Domestic	$1,131,112	$7,691,416
Foreign	397,167	138,481
	$1,528,279	$7,829,897

The components of the Company's deferred income tax provision are as follows:

	1989	1988
Research and development costs, net of amortization	$ 547,000	$432,000
Allowance for uncollectible accounts receivable, vacation and other reserves	(281,000)	–
Inventory adjustments	(228,000)	–
Net operating loss and tax credit carryforwards	92,000	–
Excess of tax over financial statement depreciation	65,000	106,000
Other, net	2,000	(2,000)
	$ 197,000	$536,000

Total income taxes reported are different than the amount that would have been computed applying the federal statutory tax rate to income before income taxes. The difference is attributable to the following:

	1989	1988
Computed at federal statutory rate of 34% (37% in 1988)	$520,000	$2,897,000
State income taxes, net of federal tax benefit	60,000	262,000
Nondeductible amortization	70,000	–
Nondeductible travel expense	42,000	–
Research and development tax credits	–	(500,000)
Investment tax credits	(45,000)	(201,000)
Foreign tax credits	–	(200,000)
Other, net	18,000	3,000
	$665,000	$2,261,000

The extraordinary credit in 1988 of $1,411,000 resulted from the use of net operating loss carryforwards after giving effect to the alternative minimum tax and limitations on the use of tax credits. At March 31, 1989, the Company has approximately $600,000 of research and development tax credit carryforwards available to reduce future federal income tax liability through 2003.

During 1989, $881,000 in income tax payments were made. No income tax payments were made in the two-year period ended March 31, 1988, due to the Company's net operating loss carryforward position.

Note K Industry Segment, Geographic and Customer Information

The Company, which operates in a single industry segment, designs, develops and markets systems and software for computer-aided publishing applications. No customer accounted for 10% or more of revenues in fiscal 1989, 1988 or 1987.

Information regarding geographic areas at March 31, 1989 and 1988, and for the years then ended is as follows:

	Geographic Area				
March 31, 1989 and for the year then ended	United States	Canada	Other	Eliminations	Total
Sales to unaffiliated customers	$70,063,686	$6,863,624	$5,852,871	–	$82,780,181
Intercompany transfers	3,441,000	–	–	$(3,441,000)	–
Net revenues	$73,504,686	$6,863,624	$5,852,871	$(3,441,000)	$82,780,181
Income (loss) from operations	$ 2,345,493	$ (51,583)	$ 403,053	$ (185,467)	$ 2,511,496
Identifiable assets	$71,931,316	$5,253,917	$4,911,357	$(8,045,437)	$74,051,153
March 31, 1988 and for the year then ended					
Sales to unaffiliated customers	$54,519,532	$2,944,621	$ 924,568	–	$58,388,721
Intercompany transfers	1,773,039	–	–	$(1,773,039)	–
Net revenues	$56,292,571	$2,944,621	$ 924,568	$(1,773,039)	$58,388,721
Income from operations	$ 7,427,572	$ 146,003	$ 5,824	$ 5,713	$ 7,585,112
Identifiable assets	$65,270,102	$2,391,075	$1,535,619	$(7,434,332)	$61,762,464

Intercompany transfers between geographic areas are accounted for at prices that approximate prices charged to unaffiliated customers. United States export sales approximated 3%, 14% and 8% of revenues during fiscal 1989, 1988 and 1987, respectively.

Note L Research and Development Agreements

On March 31, 1987, the Company entered into an arrangement with ML Technology Ventures, L.P. (MLTV) to perform ongoing product development for the personal-computer and international electronic publishing markets. MLTV, a research and development limited partnership sponsored by Merrill Lynch Capital Markets, provided the Company with $3,500,000 for services performed through September 1988.

As provided for in a related Agreement, the Company purchased an option for $378,125 to enter into a joint venture with MLTV for commercialization of these products so developed. The Company exercised this option in September 1987 and made an initial cash investment of $25,000 in the joint venture. The Company is committed to manufacture and market such products 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 receives 97% of the revenues from the sale of such products. In the quarter in which the joint venture's cumulative profits allocable to MLTV equal or exceed $1,500,000, the Company will have a 30-day option to purchase all of MLTV's rights to the technology for $5,500,000. In connection with the arrangement, MLTV obtained a warrant at a cost of $378,125 to purchase 125,000 shares of the Company's common stock through March 1994 at $13.50 per share. This amount is included in additional paid-in capital.

On March 31, 1987, MLTV advanced $600,000 to the Company as a deposit to perform qualified research activities. During the year ended March 31, 1988, the Company received $2,900,000 in additional research funds. The Company incurred $800,000 in expenses during the year ended March 31, 1989 ($2,700,000 in 1988), attributable to the research performed under this agreement. The reimbursement for these expenses has been presented in the consolidated financial statements net of the related research and development costs of the same amount. During 1989 the Company recorded revenues from the sale of joint venture products of $7,475,000 ($797,000 in 1988).

On October 21, 1988, the Company entered into a joint venture with PruTech Research and Development Partnership III (PruTech) to perform ongoing product development for various electronic publishing markets. PruTech, a research and development limited partnership sponsored by Prudential-Bache Securities Inc., is providing the Company with $3,000,000 for services to be performed through September 1989. 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 $3,000,000 being provided by PruTech, the Company may be required to continue the research with its own funds, up to a maximum of $560,000 over the $3,000,000.

The Company is committed to manufacture and market the products so developed for the joint venture. In return, the Company receives 95% of the revenues from the sale of such products during the first three years and 70% thereafter. In October 1989 the Company can acquire an option for $150,000 to purchase PruTech's interest in the joint venture. With this option, the Company can purchase PruTech's interest any time prior to October 15, 1991, for $7,106,000, less any profits received to date by PruTech from the joint venture. Commencing February 1, 1992, and for each quarter thereafter, PruTech can purchase the Company's interest in the joint venture at a price equal to 10 times the joint venture's net profits for the previous quarter. In connection with the arrangement, PruTech obtained a warrant at a cost of $180,000 to purchase 275,000 shares of the Company's common stock through October 1995 at $6.75 per share. This amount is included in additional paid-in capital. The Company also received $150,000 from the joint venture as a licensing fee for the use of certain underlying technology by the joint venture.

Note L Research and Development Agreements Continued

During the year ended March 31, 1989, the Company received $2,250,000 in research funds and incurred $2,400,000 of expenses attributable to the research being performed under this agreement. The reimbursement for these expenses, including $150,000 owed the Company at March 31, 1989, has been presented in the consolidated financial statements net of the related research and development costs of the same amount. No revenues have been recorded through March 1989 from the sale of joint venture products.

Note M Acquisition

On July 29, 1988, the Company completed its acquisition of Interleaf Canada Inc., the exclusive distributor of the Company's products in Canada. The acquisition was accounted for under the purchase method of accounting. On October 26, 1987, the Company had acquired an option to purchase Interleaf Canada, bringing the Company's effective ownership interest in Interleaf Canada to 100%. Accordingly, balance sheet accounts of Interleaf Canada have been consolidated with those of the Company at March 31, 1988 and 1989, and the results of operations of Interleaf Canada for the six-month period ended March 31, 1988, and the year ended March 31, 1989, have been included in the consolidated statement of operations of the Company. Prior to October 1987 the Company's share of Interleaf Canada's operating results was reflected in the consolidated statement of operations on the equity basis of accounting. The excess of the Company's investment in Interleaf Canada, at the date of final acquisition, over the net book value of Interleaf Canada (approximately $961,000) amounted to approximately $5,000,000 and is being amortized over a period of 25 years.

Had the acquisition occurred at the beginning of either fiscal 1988 or 1987, the pro forma unaudited consolidated results of operations would have been as follows:

Year ended March 31	1988	1987
Revenues	$59,357,000	$37,914,000
Net income (loss)	6,617,000	(1,477,000)
Net income (loss) per share	.56	(.14)

Report of Independent Auditors

Board of Directors
Interleaf, Inc.
Cambridge, Massachusetts

We have audited the consolidated balance sheets of Interleaf, Inc. and subsidiaries as of March 31, 1989 and 1988, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended March 31, 1989. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Interleaf, Inc. and subsidiaries at March 31, 1989 and 1988, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 1989, in conformity with generally accepted accounting principles.

As discussed in Note J to the consolidated financial statements, effective April 1, 1988, the Company changed its method of accounting for income taxes to comply with the provisions of Statement of Financial Accounting Standards Number 96 *Accounting for Income Taxes.*

Ernst & Whinney

Boston, Massachusetts
May 1, 1989

Supplemental Financial Information

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1989 and 1988, and the market range for the Company's common stock for those periods:

Quarter ended	June 30	September 30	December 31	March 31	Year
Fiscal 1989					
Revenues	$17,051,319	$18,395,351	$21,326,743	$26,006,768	$82,780,181
Net income	108,562	122,698	82,362	549,657	863,279
Net income per share	.01	.01	.01	.05	.07
Common stock prices					
High	20 1/8	13 1/2	9 1/4	9 5/8	20 1/8
Low	11 3/4	8 3/4	6 3/8	6 5/8	6 3/8
Fiscal 1988					
Revenues	$10,533,335	$12,732,470	$17,006,309	$18,116,607	$58,388,721
Income before extraordinary credit	533,512	967,833	1,648,004	2,419,548	5,568,897
Net income	722,512	1,309,333	2,479,004	2,469,048	6,979,897
Income per share before extraordinary credit	.05	.08	.14	.20	.47
Net income per share	.06	.11	.21	.21	.59
Common stock prices					
High	20 3/8	21 1/4	24 1/8	21 3/8	24 1/8
Low	13 7/8	14 5/8	11 1/4	14 7/8	11 1/4

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 May 1, 1989, there were 1,292 holders of record of the Company's common stock.

Selected Five-Year Financial Data

Year ended March 31	1989	1988	1987	1986	1985
For the year					
Total operating revenues	$82,780,181	$58,388,721	$37,173,162	$18,645,883	$ 8,334,586
Net income (loss)	863,279	6,979,897	(410,121)	(2,443,401)	(1,628,509)
Net income (loss) per share	.07	.59	(.04)	(.29)	(.26)
At year end					
Total assets	74,051,153	61,762,464	44,734,377	18,676,887	8,642,585
Long-term obligations	13,246,381	4,812,939	1,362,892	1,901,608	1,369,848
Total shareholders' equity	45,064,238	42,992,655	35,290,459	11,020,251	4,475,754

Company Officers

David A. Boucher
President and Chief Executive Officer

Harry A. George
Vice President of Finance and Chief Financial Officer

George D. Potter, Jr.
Senior Vice President, Sales Operations

William W. Barnes
Vice President of Human Resources

Lawrence S. Bohn
Vice President of Product Management and Planning

David L. Cross
Treasurer

Stephen J. Cummings
Vice President, International Operations

David Downs
Vice President of Manufacturing

Frederick J. Egan
Vice President of Third-Party Marketing

Edmund W. Grossman
Vice President of Operations

John K. Hyvnar
General Counsel

Edward B. Mallen
Vice President of U.S. Sales

Michael Mark
Vice President of System Integration

Stephen D. Pelletier
Vice President of Engineering and Chief Technical Officer

Steven M. Schwartz
Vice President of Marketing

Andrew J. Van Abs
Vice President of Engineering–Peripherals Technology

George R. Vaughn
Controller and Principal Accounting Officer

Board of Directors

David A. Boucher
President and CEO
Interleaf, Inc.

Harry A. George
Vice President of Finance and CFO
Interleaf, Inc.

George D. Potter, Jr.
Senior Vice President, Sales Operations
Interleaf, Inc.

Frederick B. Bamber
General Partner
Applied Technology Partners

Dr. Michael Hammer
President
Hammer & Company, Inc.

Patrick J. Sansonetti
Senior Vice President
Advent International Corporation

Interleaf Fellows

Elected by the engineering staff in recognition of technical excellence:
James L. Crawford
Mark S. Dionne
K. Deborah Landsman
Kimbo B. Mundy
Kirk L. Reistroffer
Patrick J. Slaney
Robert Watkins

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 11, 1989 at 10 a.m. at the Bank of Boston, 100 Federal Street, Boston, MA.

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

Transfer Agent
The First National Bank of Boston
Boston, MA

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, MA

Legal Counsel
Hale and Dorr
Boston, MA

Corporate Directory

Corporate Headquarters
Ten Canal Park
Cambridge, MA 02141
(617) 577–9800

25 First Street
Cambridge, MA 02141

Manufacturing Headquarters
46 Jonspin Road
Wilmington, MA 01887

Sales Offices

United States
Phoenix, Arizona; Irvine, California; Los Angeles, California; San Diego, California; Santa Clara, California; San Francisco, California; Denver, Colorado; Norwalk, Connecticut; Washington, D.C.; Tampa, Florida; Atlanta, Georgia; Chicago, Illinois; Baltimore, Maryland; Boston, Massachusetts; Detroit, Michigan; Minneapolis, Minnesota; St. Louis, Missouri; Iselin, New Jersey; New York, New York; Melville, New York; Raleigh, North Carolina; Cleveland, Ohio; Philadelphia, Pennsylvania; Dallas, Texas; Houston, Texas; Seattle, Washington

Canada
Vancouver, British Columbia; Ottawa, Ontario; Toronto, Ontario; Montreal, Québec

International
Brussels, Belgium; London, England; Manchester, England; Paris, France; Hong Kong; Milan, Italy; Zurich, Switzerland; Kista, Sweden; Frankfurt, West Germany; Munich, West Germany

About this Annual Report

This annual report was created by Interleaf's Corporate Design Group with Interleaf TPS Release 4 software. Text and financial information were entered by people in various departments throughout the Company and transferred electronically to the Design Group for final formatting. Files were then sent directly to a typesetter for final output of camera-ready pages.

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