INTERLEAF ANNUAL REPORT 1990

Active documents are aware of their environment, so they can not only access information but also evaluate and act on it.

In March, Interleaf announced "active documents" — documents that are actually aware of their environment and can access, evaluate and act on information.

This breakthrough technology enables Interleaf to build custom electronic-publishing applications for our customers — key to our goal of becoming a strategic supplier of software and services.

Throughout this Annual Report you will see examples of how our customers are using active documents and other Interleaf solutions to access, present, manage, distribute and store information.

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In the first six months of fiscal 1990, new conditions in the computer industry made it apparent that Interleaf needed to make significant changes in its business.

Deep discounting by computer manufacturers as well as the rapid pace of new product offerings necessitated that Interleaf stop re-selling hardware; at the same time we saw an increasing demand for support and services to complement our growing software sales.

During the second half of the year, we accomplished what we believe was necessary to take us through a major business transition successfully: We exited the hardware business, strengthened the management team and announced breakthrough technology that will enable us to lead the market in information publishing software and services.

Most important, we have begun implementing a new strategy that leverages our expertise, technology and market position. Our new direction calls for Interleaf to become a strategic supplier of information publishing software and services — complete publishing solutions that are configured to the information flow of individual customers.

Exiting Hardware Business When we started out in the electronic publishing business, most customers bought turnkey systems (workstations plus software) for publishing applications.

But the workstation market over the past 18 months has turned into a commodity market, with many hardware vendors offering end-user discounts on their products that we, as a reseller, could not match. Although the change in the hardware market is favorable to Interleaf in the long term — it makes the hardware necessary to utilize our high-productivity software more widely available — it was no longer possible for us to make a profit on hardware sales. In November, we made the decision to exit the hardware side of the business, and reduced the domestic workforce by 18%.

We are re-focusing Interleaf's resources on high-margin software and services. This, we believe, is where we can provide the greatest value to our customers.

Strengthened Management To help the Company implement these major shifts in our business strategy, we have strengthened the management team.

In November, Robert Weiler joined Interleaf as president and chief operating officer, a newly created position. Bob was most

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recently president of Cullinet Software Inc. His number-one goal is to improve Interleaf's profitability.

In August, chief financial officer Harry George, Interleaf's co-founder, resigned for health reasons. Harry continues as a member of the Interleaf Board of Directors and as a consultant to management.

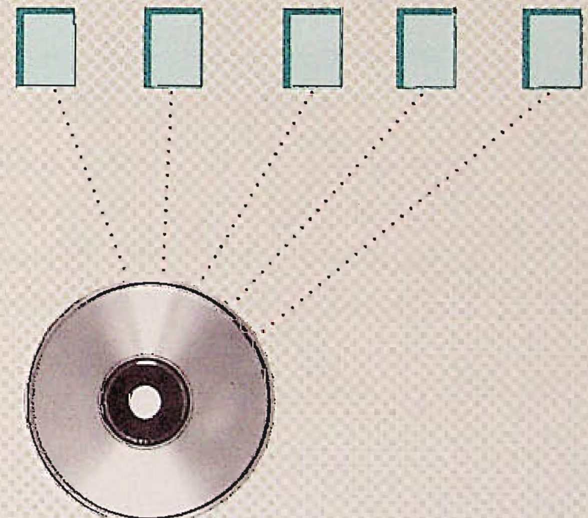
We were pleased to welcome David Collard as our new CFO, charged with ensuring focus on profitability and return on equity. Dave was formerly CFO at Prime Computer, Inc.

In June 1990, Mark Ruport joined Interleaf as senior vice president of worldwide sales. Mark is responsible for Interleaf's worldwide direct sales operations, value-added reseller (VAR) channel, vertical market business units and systems integration and services offerings. Mark comes to Interleaf from Informix Software, Inc., where he was senior vice president of sales.

Jim Meyer joined us in May 1990 as vice president of systems integration. Jim has 16 years' experience in information management, government and commercial project management and office automation. Jim was most recently vice president and chief operating officer of Information Analysis, Inc.

The Amoco Production Company
Houston, Texas

At Amoco, every project requires thousands of pages of engineering specifications. Interleaf worked with Amoco to help develop on-line forms with customized menus that guide the engineers through the documentation process. The forms have thousands of links to industry standards on CD-ROM, and to the Amoco standards and help screens.



Financial Results When we made the decision to exit the hardware business, we took a one-time after-tax restructuring charge of $13.5 million ($1.16 per share). Despite the fact that we were no longer selling hardware, Interleaf's revenues for fiscal 1990 increased to $88.8 million, compared with $82.8 million for fiscal year 1989. Largely due to the restructuring charges, we lost $16 million ($1.37 per share) compared with a profit of $863,000 ($0.07 per share) for fiscal year 1989.

We estimate that exiting the hardware business will save us $6 million in annual expense. We've also taken several other steps to improve Interleaf's financial performance with the emphasis on improving the cash flow:

- We reduced our inventory levels from $11.6 million at the end of our 1989 fiscal year to $1.4 million a year later.
- We reduced Interleaf's fixed-asset purchases from an average of $2.4 million in the first two quarters of fiscal year 1990 to $0.6 million in the fourth quarter.
- We improved our accounts receivable collection. In the fourth quarter of fiscal year 1989, the average time between invoicing and collection was 110 days. For the same quarter in fiscal year 1990, that number was reduced to 95 days.

Despite the fact that we were no longer selling hardware, Interleaf's revenues for fiscal 1990 increased to $88.8 million, compared with $82.8 million for fiscal year 1989.

As a result of these steps we were cash-positive in the last quarter of fiscal 1990. (See Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 15.)

Strategy In recent years, people have been exposed to a flood of new technology. Developers are bringing new products to market faster than consumers can absorb them. As a result, computing environments have become increasingly complex and many customers need help to keep up and take full advantage of new technology.

Customers need more than new software; they need service and support to back up what they already have. We are positioning Interleaf to be a strategic supplier of software and services by leveraging our strengths:

- Feature-rich software products that run on all the major hardware platforms.
- Expertise in publishing applications.
- A new generation of configurable software that can be customized to individual workflows. (We'll describe this technology in more detail below.)

CUSTOMER PROFILE

Texas Instruments
Dallas, Texas

Texas Instruments uses a specially configured Interleaf system to automatically generate data sheets from input files. Texas Instruments plans to extend the application to automatically populate tables — the system will gather the appropriate information from a database, perform the necessary calculations and insert the figures into the appropriate cells.

- High-end products for managing large information-based publishing systems — from automatically bringing data into documents to tracking and distributing appropriate versions.
- Worldwide software and support.

Interleaf's consulting and integration services can add significant value for our customers, both in individual accounts with major sales potential, and in accounts in the vertical markets we have targeted.

We have already achieved a leadership position in technical documentation applications, including aerospace and CALS (Computer-aided Acquisition and Logistic Support, a Department of Defense-mandated data management standard), pharmaceuticals, commercial aviation and CASE (computer-assisted software engineering). We are developing special tools, services and support that can be of significant value to companies in each of these areas. We have also developed strengths in publishing applications for financial services and management consulting, and will continue to add target markets as our business grows.

Key Programs We recently announced several key programs to help us better meet customer needs and implement our new strategy:

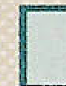
We are creating strategic business units focused on target markets to allow us to become partners with our largest customers.

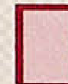
- We are creating strategic business units focused on target markets to allow us to become partners with our largest customers. Our newly formed commercial aviation business unit has demonstrated initial success with major sales at America West Airlines and Canadair, the Canadian aircraft manufacturer.
- Our value-added reseller channel in the United States now shares management with Interleaf's U.S. direct sales organization. Our direct sales force is concentrating on opportunities where service is a significant component, while the VARs handle accounts with smaller service needs. To implement the program, we worked closely with our hardware partners to identify and recruit top VARs.
- We are aggressively building our systems integration capabilities to help our customers adopt the most effective solutions.
- We held our first worldwide Interleaf users conference (ICON), attended by more than 500 customers — by all measures a tremendous success. We will hold ICON twice a year, once in the United States and once in Europe. The conference is an opportunity to get feedback directly from customers, and to help us focus on the products and services that best meet their needs.

Other programs are aimed specifically at seeding the market and reducing the cost of distribution:

Saab Aircraft
Linköping, Sweden

Interleaf has prototyped an electronic distribution system that allows Saab to deliver an Illustrated Parts Catalog for its 340 Aircraft to customers on CD-ROM. One CD holds the complete set of fully referenced text-and-graphic documentation — more than 400 megabytes of information — and offers hypertext browsing on both PCs and workstations.





- Our new VAR program allows authorized VARs to sell all Interleaf products, not just the limited set they sold previously.
- We are now making our university publishing software package (UPS) available free to accredited colleges and universities. Through our Partners in Publishing program, we are encouraging our university users to do important "shareware" development work.

Technology To maintain our leadership as a strategic supplier of software and services, our technology must be at the cutting edge.

In March, we announced breakthrough technology we call "active documents" — Interleaf documents that are actually aware of their environment and can access, evaluate and act on information. Active documents have all the power of Interleaf's publishing functionality — such as text, graphics, charts and tables — so they can take information from any source and display it in a variety of ways.

To illustrate the far-reaching potential of active documents, we have demonstrated possible uses:

- A weekly report. When opened, it automatically extracts information from a database about each member of your department.

Active documents are actually aware of their environment and can access, evaluate and act on information.

The document evaluates the data and builds a timeline and a table tracking each person's progress. If you change the table, the database and the timeline are simultaneously updated. When the document is closed, it automatically sends itself to your manager.

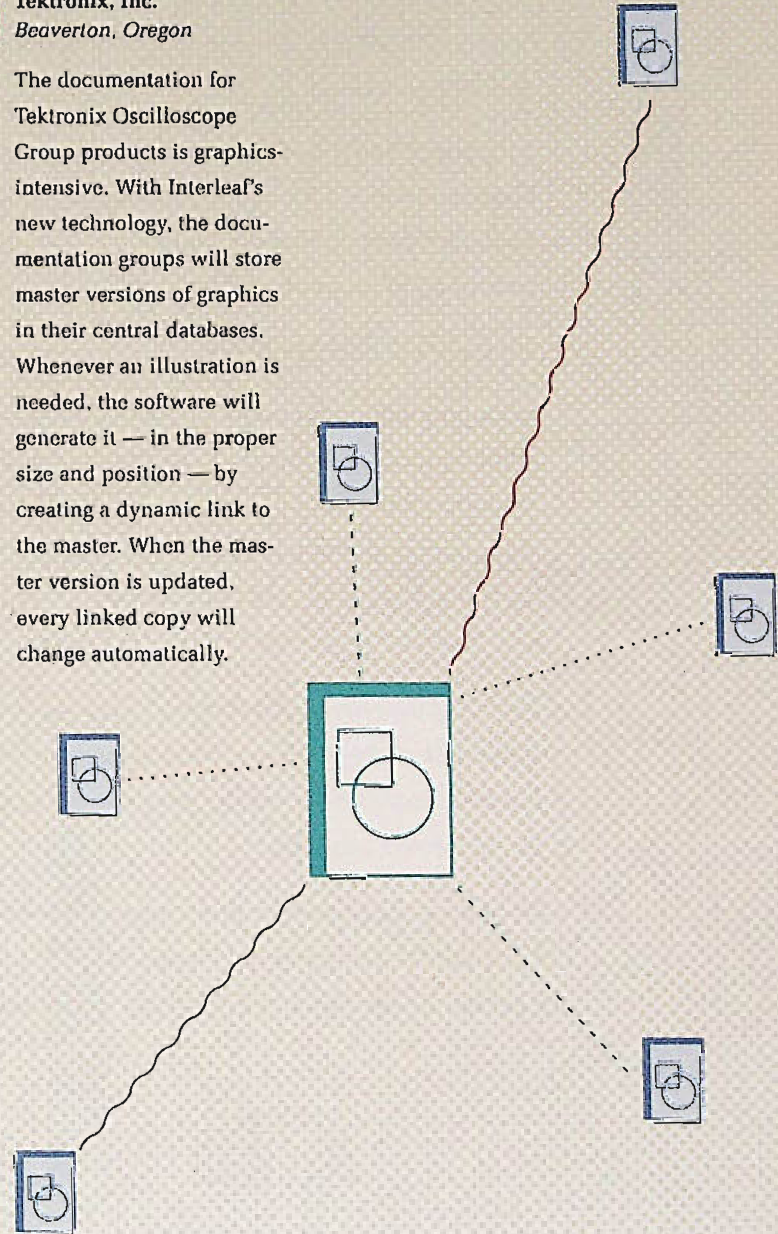
- A document linked to Lotus 1-2-3 for Sun Microsystems. This document displays the spreadsheet data in several ways — as a chart, a table of numbers and an illustration that shows parts scaled according to their manufacturing costs. When you select the chart for editing, the system automatically loads Lotus. Make the necessary changes in your spreadsheet, and the new data is reflected in the chart, table and illustrations displayed in the Interleaf document.

- A proposal. Once the document is made aware of who's using it and what level of security clearance the user has, it knows the appropriate contents to display and which interface to invoke.

The possibilities are endless. Interleaf active document technology allows us to quickly and easily build and customize applications for specific industries, corporations, departments, even individuals. Since we re-program documents instead of our core software, we can develop a highly complex application in

Tektronix, Inc.
Beaverton, Oregon

The documentation for Tektronix Oscilloscope Group products is graphics-intensive. With Interleaf's new technology, the documentation groups will store master versions of graphics in their central databases. Whenever an illustration is needed, the software will generate it — in the proper size and position — by creating a dynamic link to the master. When the master version is updated, every linked copy will change automatically.



days. Because active documents can be customized for each customer's workflow, they are an integral piece of our software and services strategy.

Response to active documents has been overwhelmingly positive. Articles in such publications as *The New York Times*, *Business Week* and the computer magazines hailed our new technology as an innovation in information management.

We made several other technology announcements during 1990:

In keeping with our commitment to compatible software for all major hardware platforms, we introduced Interleaf TPS software for several new computers: the Hewlett-Packard 9000 family of workstations; Digital Equipment Corporation's VAXstation 3100 and DECstation 3100; Sun Microsystem's SPARCstations and the new IBM RISC System/6000 line of computers.

Rounding out our corporate-wide solution, we announced new software that allows users to perform high-speed printing and to distribute Interleaf documents, complete with text and graphics, via mainframe terminals.

We announced support for X windows. X provides a set of standards for displaying and manipulating on-screen text and graphics. Support for X is in line with our commitment to

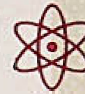
Maintaining a strong international presence is crucial to Interleaf's success. . . . We are the clear leader in offering multilingual products and international support.

multi-platform publishing, and brings our users even greater freedom in choosing computers and display devices that best suit their needs.

International Growth International sales currently account for 30% of our revenues, and continue to show substantial growth.

We concluded the acquisition of our French affiliate, Interleaf France S.A., which had been founded in 1986 as a joint venture between Interleaf and Compagnie Financière du Scribe. Pursuant to the terms of the joint venture, we exercised our option to buy out CFS and acquired the remaining 80% equity held by CFS.

Maintaining a strong international presence is crucial to Interleaf's success. Many of our domestic customers have affiliates in other countries, and some of these have standardized internationally on Interleaf. The 1992 initiative in Europe will create major revenue opportunities. We believe we are in a unique position to take advantage of these opportunities, as we are the clear leader in offering multilingual products (Interleaf software is available in 13 languages) and international support.



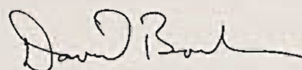
Atomic Energy of Canada, Ltd.
Toronto/Mississauga, Ontario

Building a new power plant typically involves half a million pages of documentation for the nuclear portion alone, and every document is heavily revised. Interleaf developed a document management solution for AECL that automatically routes documents for approval, tracks revisions and stores final versions in an electronic vault that can be accessed only with special permission.

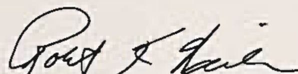
Summary We believe Interleaf's new strategy — selling high-value information publishing software and services into target markets — will show long-term results.

With active documents, Interleaf has seized the technological high ground. This exciting new technology enables the Company to offer our customers software and service solutions that no one else in the industry can provide.

We have the strategy and the technology in place. Our challenge is to execute the programs necessary to make a significant improvement in Interleaf's financial results. We are beginning fiscal 1991 as a year of transition as we put these elements to work, and turn our growing revenues into profits.



David A. Boucher
CEO and Chairman



Robert K. Weiler
President and COO

Our challenge is to execute the programs necessary to make a significant improvement in Interleaf's financial results.

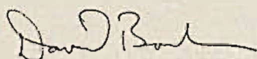
FINANCIAL STATEMENTS

REPORT OF MANAGEMENT

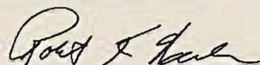
The management of Interleaf, Inc. and its subsidiaries is responsible for preparing the accompanying financial statements and for ensuring their integrity. The statements were prepared in accordance with generally accepted accounting principles. In instances where exact measurement is not possible, the 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.

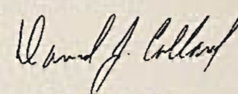
The consolidated financial statements of Interleaf, Inc. and its subsidiaries have been audited by Ernst & Young, independent auditors, whose report is contained herein. Their audit includes an evaluation of the Company's accounting systems and internal controls, as well as performance of other auditing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



David A. Boucher
Chief Executive Officer, Chairman



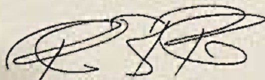
Robert K. Weiler
President, Chief Operating Officer



David J. Collard
Chief Financial Officer

REPORT OF AUDIT COMMITTEE CHAIRMAN

The Audit Committee of the Board of Directors is composed of two independent directors. The Committee held five meetings during fiscal 1990. 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 & Young as the Company's independent auditors. The Committee discussed with Ernst & Young the overall scope and specific plans for their audit and the adequacy of the Company's internal controls. The Committee met with Ernst & Young, 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

Year ended March 31	1990	1989	1988
Revenues	100%	100%	100%
Costs and expenses:			
Cost of products and services sold	28	34	31
Selling, general and administrative	56	50	44
Research and development	18	13	12
Restructuring charge	15	–	–
Total operating costs and expenses	117	97	87
Income (loss) from operations	(17)	3	13
Interest income (expense), net	(1)	(1)	1
Other expense	–	–	–
Income (loss) before income taxes	(18)	2	14
Provision for income taxes	–	1	4
Income (loss) before extraordinary credit	(18)	1	10
Extraordinary credit	–	–	2
Net income (loss)	(18)%	1%	12%

Results of Operation During fiscal 1990, the Company initiated a significant restructuring of its corporate infrastructure and began a repositioning of its basic business direction. These two fundamental changes have substantially impacted and will continue to strongly influence the Company's financial condition and operating results. In the past, the Company had developed into a reseller of multiplatform workstations and related peripheral hardware, bundled with the Company's own proprietary software. As a result, the Company built a corporate infrastructure to purchase inventory, re-sell and maintain this hardware. Specifically, this required significant investments in (1) facilities, (2) inventory and fixed assets and (3) human resources committed to supporting the overall hardware business. While this "model" served the Company well initially, it became evident that it no longer leveraged the strengths of the Company and, consequently, was inconsistent with the strategic direction for the Company. As workstations became more available in the marketplace, manufacturers began to aggressively reduce their prices. It was more economical for customers to buy workstations directly from the manufacturers and software directly from Interleaf. From the customers' perspective, the Company's real value-added component was its software and supporting services.

These conditions led the Company to two conclusions: (1) revenues and profit margins were declining from the hardware business, but the costs of maintaining the infrastructure to support the hardware business continued to increase; and (2) in order to leverage the Company's software and distinguish it from competitors, Interleaf had to offer specialized services and training to customers to meet their different and unique publishing needs.

Based on these conclusions, in November 1989 the Company exited the hardware business and began the process of primarily providing its multiplatform software blended with customized services, to leverage its technology. Exiting the hardware business required the elimination and/or reduction of a significant part of the Company's corporate infrastructure. A pre-tax restructuring provision of approximately $13.9 million was recorded in the third quarter of fiscal 1990, comprised as follows: Inventory and Fixed Assets ($6 million), Reduction in Employment ($2 million) and Facilities Reduction ($5.9 million).

A review and analysis of the Company's past operating performance and its future performance can only be understood in the context of the Company's restructuring and the new direction outlined above. Because of the significant shift in the Company's business, financial comparisons from the previous years may not be entirely useful. Certain specific areas, however, of the Company's financial operations need to be analyzed in order to understand the new direction of the Company.

Total revenues for fiscal 1990 were $88.8 million, compared to $82.8 million and $58.4 million for fiscal 1989 and 1988, respectively. Moreover, the Company incurred a net loss of approximately $16 million for fiscal 1990 ($13.5 million after tax attributable to the restructuring), compared to profits of $.8 million and $5.6 million for fiscal 1989 and 1988, respectively. Overall, the slower growth and deteriorating profitability reflected in this trend explains the ultimate basis for exiting the hardware business, and emphasizes why the Company took action in November 1989. Four important points need to be understood.

Software and Services Have Higher Margins A mere comparison of the Company's total revenue, year to year, does not reveal the economic impact of software revenue vis-à-vis hardware revenue. This point is illustrated by a comparison of the Company's fourth quarters for fiscal 1989 and 1990. In the fourth quarter of fiscal 1990 (the first quarter after the restructuring when only minimal hardware was sold), total revenue was $22.9 million, down from $26 million in the fourth quarter of fiscal 1989 (which reflected significant hardware sales). However, while total revenue decreased $3.1 million, gross profit increased by $1.1 million. This comparison illustrates an important underpinning of the Company's new direction. In today's marketplace, software and services are generally more profitable than hardware. By exclusively providing software and specialized services, the Company plans to fully leverage its technology to maximize the Company's profitability.

International Growth Is Strong International revenue accounted for $27 million in fiscal 1990, compared to $18.2 million for fiscal 1989. This represents a 48% increase in revenue over the previous year. Three points need to be made in understanding this trend: (1) Unlike domestic sales, the Company's international operations have historically offered primarily software and services. Thus, these numbers contain very little hardware revenue. In many respects, the Company used its European operations, in part, as a model in its restructuring. (2) The Company's full foreign-based language products (13 languages) on multiple platforms have been sold abroad for only approximately two years. This revenue growth indicates rapid and strong customer acceptance in the international marketplace for the Company's products. (3) The Company has a unique competitive advantage in Europe, since the Company's domestic competitors have not significantly expanded overseas and/or have not yet fully developed comparable foreign language-based products.

Domestic Revenue Has Remained Relatively Flat Over the past two years, U.S. revenues have been relatively flat. For fiscal 1990, domestic revenues were $61.8 million, compared to $64.6 million in fiscal 1989. This problem is essentially attributable to three factors: (1) The fundamental changes that have occurred in the hardware business, as discussed above. (2) Domestic competition has been increasing, as lower-end products of competitors have enhanced functionality. This has resulted in downward price pressure in the marketplace. (3) Customers are unable to utilize the full functionality and potential of the Company's software without the Company providing specialized services and training. Without these, the Company cannot fully leverage its technological advantage over its competitors.

In response to these marketplace changes, the Company embarked on its new strategy of selling its software bundled with specialized services and training. The Company will attempt to directly integrate these "products" with customers' specific publishing needs. The Company is currently adding expertise in this area of systems integration, and is committed to directing significant resources to this area.

Selling, General and Administrative Expenses as a Percentage of Revenues Are Too High Due primarily to the restructuring and shift in the strategic direction of the Company, a meaningful year-to-year comparison of the Company's operating expenses is difficult. While the Company incurred a one-time pre-tax restructuring charge of $13.9 million, the Company anticipates saving approximately $6 million annually principally from reduced facilities and staffing requirements. This savings results from the Company's new direction as a software and services provider: the corporate infrastructure previously needed to support the hardware business has been eliminated.

This reduction should help improve the Company's future operations. The Company does, however, recognize its relatively high costs of selling, general and administrative ("SG&A"). Approximately 56% of the Company's revenues for fiscal 1990 were offset by SG&A. The Company has begun three major initiatives to deal with this problem: (1) The Company has started to select key vertical markets where its products are needed to solve complex and unique publishing requirements. In these select vertical markets, it will be essential to the success of the Company to increase overall revenues per transaction. A sale should involve not only software, but also specialized services and training. (2) The Company will have its direct sales force concentrate on those select vertical markets and major accounts where specialized services and training are significant and shell have its value-added reseller channel handle the other opportunities. (3) The Company will maximize its opportunities to generate revenue from services previously provided at no additional charge as part of the bundled sales price for the total system (hardware and software).

These initiatives are not only intended to maximize revenue, but also to deliver publishing solutions to customers in cost-effective ways.

Research and Development The Company plans on continuing to expend significant resources on research and development ("R&D") to maintain its technological leadership in the industry. In fiscal 1990, the Company spent $15.6 million on R&D, an increase of $4.9 million over R&D expenditures for fiscal 1989 of $10.7 million. Only $2.9 million, however, of this increase can be deemed an actual increase in R&D, since the Company received only $.4 million from joint venture funding for fiscal 1990 compared to $2.4 million in fiscal 1989 (see Note M to Consolidated Financial Statements). The Company expects to continue this level of commitment to R&D.

Liquidity and Capital Resources In September 1989, the Company received approximately $15 million from its private placement of its Senior Series B Convertible Preferred Stock. Of this amount, approximately $7 million was expended to complete the Company's acquisition of Interleaf France S.A., with the balance of the proceeds being used to pay down its outstanding debt under its revolving credit agreement with the First National Bank of Boston. During the balance of the year, the Company satisfied its working capital needs from cash generated from operations.

Due primarily to the restructuring, both the Company's working capital and its working capital needs have significantly changed. Working capital declined from $30.8 million at the end of fiscal 1989 to approximately $17.2 million (excluding $6.7 million for accrued restructuring reserves) at the end of fiscal 1990. Approximately $9 million of this reduction was attributable to the elimination of inventory from working capital that was financed in 1989 by long-term borrowings. As a provider of software and services, the Company should have lower working capital and fixed-asset requirements than historically needed by the Company.

Moreover, as a software and services provider, the Company will also have lower facilities requirements. The Company plans on consolidating its two corporate office facilities in Cambridge, Massachusetts and its facility in Wilmington, Massachusetts, cumulatively totalling approximately 280,000 sq. feet, into one facility having approximately 140,000 sq. feet, located in Waltham, Massachusetts.

The Company believes its working capital needs can be satisfied from cash generated from operations. The Company has, however, entered into joint venture agreements to facilitate the development and sale of new products with MLTV and PruTech (see Note M to Consolidated Financial Statements). Depending upon the level and timing of acceptance of the products developed under these agreements, the Company may find it appropriate to expend approximately $12.5 million to purchase the technology and products owned by these joint ventures in either fiscal 1991 or 1992. Moreover, in light of the continued growth of its exclusive distributor for the Company's products in Germany, the Company is closely reviewing its option to acquire that operation for approximately $7 million in either fiscal 1991 or 1992.

Currently, the Company has the capability to borrow approximately $13 million under its revolving credit agreement with the First National Bank of Boston. Moreover, to meet the potential capital needs described above, the Company will explore public and/or private debt or equity financing alternatives during fiscal 1991.

CONSOLIDATED STATEMENTS OF OPERATIONS

Year ended March 31	1990	1989	1988
Revenues			
Products	$ 62,902,925	$67,694,642	$47,104,420
Service	14,755,275	11,436,644	6,239,726
Training, porting and distribution rights	11,184,954	3,648,895	5,044,575
	88,843,154	82,780,181	58,388,721
Costs and expenses			
Cost of products and services sold	24,569,378	28,564,647	17,808,179
Selling, general and administrative	49,788,243	40,811,139	25,814,195
Research and development	15,634,767	10,677,719	7,071,235
Restructuring charge	13,900,000	–	–
Total operating costs and expenses	103,892,388	80,053,505	50,693,609
Income (loss) from operations	(15,049,234)	2,726,676	7,695,112
Interest expense	(1,311,691)	(1,254,879)	(366,431)
Interest income	384,321	271,662	611,216
Other expense	(342,298)	(215,180)	(110,000)
Income (loss) before income taxes	(16,318,902)	1,528,279	7,829,897
Provision (credit) for income taxes	(310,000)	665,000	2,261,000
Income (loss) before extraordinary credit	(16,008,902)	863,279	5,568,897
Extraordinary credit:			
Benefit from utilization of net operating loss carryforward	–	–	1,411,000
Net income (loss)	$(16,008,902)	$ 863,279	$ 6,979,897
Earnings (loss) per share			
Income (loss) before extraordinary credit	$ (1.37)	$ .07	$ .47
Extraordinary credit	–	–	.12
Net income (loss) per share	$ (1.37)	$ .07	$ .59
Shares used in computing net income (loss) per share	11,642,561	11,895,401	11,833,391

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

March 31	1990	1989
ASSETS		
Current assets		
Cash and cash equivalents	$ 4,497,319	$ 3,498,113
Accounts and royalties receivable, net of allowance of $641,000 and $598,000 for doubtful accounts, respectively	23,981,193	27,620,821
Inventories	1,420,438	11,595,477
Prepaid expenses and other current assets	1,697,564	3,048,751
Total current assets	31,596,514	45,763,162
Property and equipment, net	19,147,385	18,193,682
Excess of purchase price over net assets of businesses acquired	12,050,935	4,723,631
Other assets	5,707,454	5,370,678
	$68,502,288	$74,051,153
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 3,733,262	$ 6,353,390
Accrued expenses	4,169,345	2,965,588
Accrued compensation and related items	2,512,901	2,539,392
Unearned service revenues	2,390,902	1,749,882
Current portion of long-term debt	1,021,690	1,202,604
Current portion of capital lease obligations	560,089	143,008
Accrued restructuring costs	6,737,796	
Total current liabilities	21,125,985	14,953,864
Long-term debt, less current portion	1,601,589	12,524,700
Capital lease obligations, less current portion	310,744	721,681
Deferred taxes	268,955	733,000
Unearned revenue		53,670
Shareholders' equity		
Preferred stock, par value $.10 per share, authorized 5,000,000 shares:		
Series A Junior Participating, none issued and outstanding		
Senior Series B Convertible, issued and outstanding 2,142,857 shares	214,286	
Common stock, par value $.01 per share, authorized 20,000,000 shares, issued and outstanding 11,768,941 shares and 11,526,383 shares, respectively	117,689	115,264
Additional paid-in capital	59,125,304	43,338,753
Retained earnings (deficit)	(14,468,512)	1,540,390
Equity adjustment for foreign currency translation	206,248	69,831
	45,195,015	45,064,238
	$68,502,288	$74,051,153

See Notes to Consolidated Financial Statements.

	Preferred Stock Senior Series B	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Equity Adjustment	Total Shareholders' Equity
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
Senior Series B Convertible Preferred Stock issued	$214,286	–	14,426,781	–	–	14,641,067
Common stock issued in connection with incentive stock options exercised by employees	–	615	211,498	–	–	212,113
Common stock issued in connection with employee stock purchase plan	–	1,810	998,272	–	–	1,000,082
Proceeds from sale of warrant	–	–	150,000	–	–	150,000
Equity adjustment for foreign currency translation	–	–	–	–	136,417	136,417
Net loss	–	–	–	(16,008,902)	–	(16,008,902)
Balances at March 31, 1990	$214,286	$117,689	$59,125,304	$(14,468,512)	$206,248	$45,195,015

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended March 31	1990	1989	1988
Operating activities			
Net income (loss)	$(16,008,902)	$ 863,279	$ 6,979,897
Adjustments to reconcile net income (loss) to net cash from (used in) operating activities:			
Non-cash restructuring charge	10,952,620	–	–
Depreciation and amortization	10,087,065	6,627,240	4,071,928
Provision for losses on accounts receivable	275,741	157,329	15,000
Provision for deferred taxes	(464,000)	201,560	536,000
Increase (decrease) in unearned revenue	525,100	143,358	690,527
Changes in operating assets and liabilities:			
Accounts and royalties receivable	5,988,758	(10,620,694)	(6,396,254)
Inventories	6,279,811	(243,840)	(2,862,754)
Prepaid expenses and other current assets	1,530,820	(1,498,545)	679,726
Accounts payable, accrued expenses and accrued compensation	(4,211,558)	1,587,423	2,648,306
Foreign currency translation (gain) loss	(297,612)	11,699	62,399
Net cash from (used in) operating activities	14,657,843	(2,771,191)	6,424,775
Investing activities			
Additions to property and equipment, net	(9,150,986)	(9,715,645)	(8,517,372)
Disposals of property and equipment at net book value	1,535,964	–	–
Capitalized software development costs	(3,395,720)	(2,515,000)	(1,647,000)
Increase (decrease) in other assets	(230,485)	(948,930)	(944,472)
Payments for acquisitions of businesses, net of cash acquired	(7,055,091)	(500,000)	(5,264,152)
Net cash used in investing activities	(18,296,318)	(13,679,575)	(16,372,996)
Financing activities			
Net proceeds from issuance of preferred stock	14,641,067	–	–
Net proceeds from issuance of common stock	1,212,195	1,016,988	663,784
Proceeds from sale of warrant	150,000	180,000	–
Proceeds from long-term debt	20,416,837	12,865,538	5,112,800
Repayment of long-term debt and capital lease obligations	(31,821,636)	(4,427,490)	(842,381)
Net cash provided from financing activities	4,598,463	9,635,036	4,934,203
Effect of exchange-rate changes on cash	39,218	14,036	24,988
Net increase (decrease) in cash and cash equivalents	999,206	(6,801,694)	(4,989,030)
Cash and cash equivalents at beginning of year	3,498,113	10,299,807	15,288,837
Cash and cash equivalents at end of year	$ 4,497,319	$ 3,498,113	$ 10,299,807

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 turnkey systems and software for computer-aided publishing applications. In November 1989, the Company exited from the hardware business and has focused its marketing on software and related services.

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. Realized exchange gains or losses from transaction adjustments were reflected in operations and were not material.

Revenue Recognition Product revenues include the sale of software and hardware products that are recognized at the time of shipment, and royalty revenues which are recognized upon notification of shipment of the Company's software by the licensee to the end user. Contractual service revenues are recognized ratably over the contract period, which is generally one year, and noncontractual service revenues and training revenues are recognized as the services are performed. Porting and distribution rights revenues are recognized when the Company successfully performs the obligations specified under the agreements.

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

Inventories Inventories are valued at the lower of cost or market using the first in, first out method. Inventories at March 31, 1990 consist principally of software and related documentation. Inventories at March 31, 1989 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 acquired businesses is amortized over 25-year periods and is included in other expense.

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, when dilutive, common stock equivalents outstanding during the year. Common stock equivalents are attributable to stock options, common stock warrants and convertible preferred stock.

Basis of Presentation Certain 1989 and 1988 amounts have been reclassified to conform to the 1990 method of presentation.

NOTE B
INVENTORIES

Inventories at March 31, 1990 and 1989, consist of the following:

	1990	1989
Finished goods and work-in-process	$ 652,815	$ 3,227,636
Purchased components and documentation	767,623	4,173,789
Field service	–	4,194,052
	$1,420,438	$11,595,477

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 development 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. The unamortized portion of capitalized software development costs included in other assets amounted to $4,537,000 and $3,199,000 at March 31, 1990 and 1989, respectively. Amortization of related costs charged to expense amounted to $2,058,000, $1,147,000 and $473,000 for the three years ended March 31, 1990.

NOTE D
PROPERTY AND EQUIPMENT

Property and equipment at March 31, 1990 and 1989, consist of the following:

	1990	1989
Office and demonstration equipment	$20,935,979	$15,184,721
Development equipment	8,674,897	6,756,064
Furniture	4,491,852	3,786,314
Leasehold improvements	4,383,966	3,463,038
Building	–	846,007
	38,486,694	30,036,144
Less allowances for depreciation and amortization	19,339,309	11,842,462
	$19,147,385	$18,193,682

NOTE E
CREDIT ARRANGEMENTS

The Company has a committed, revolving line of bank credit of $20 million, which is unsecured and bears interest at prime rate plus 1/4%. Under the terms of this credit line, the Company may borrow up to the lesser of $20 million or a borrowing base amount consisting of 80% of qualified accounts receivable. A commitment fee of 3/8% of the amount of unused credit (computed on an annual basis) is charged quarterly. The Company is required to pay any borrowings under this revolving credit agreement 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. At March 31, 1990, there were no borrowings outstanding under this line of credit.

NOTE F
LONG-TERM DEBT

Long-term debt at March 31, 1990 and 1989, is as follows:

	1990	1989
Loan payable in monthly principal installments of $41,667 plus interest at prime rate plus 1/2%	$1,375,000	$ 1,875,000
Loan payable in monthly principal installments of $30,000 plus interest at prime rate plus 1/2%	900,000	1,260,000
Loan payable in monthly principal installments of $14,667 with interest at 8.85%	294,827	–
Loan payable in monthly principal installments of $9,225 plus interest at prime rate plus 3/4%	36,882	147,582
Loan payable with principal due November 1990, with interest payable quarterly at 15.1438%	–	812,800
Loan payable in monthly principal installments of $18,765 plus interest at prime rate plus 3/4%	–	206,422
Loan payable in monthly principal installments of $8,500 plus interest at prime rate plus 1 1/4%	–	25,500
Loan payable under revolving credit agreement	–	9,400,000
Other	16,570	–
	2,623,279	13,727,304
Less current portion	1,021,690	1,202,604
	$1,601,589	$12,524,700

Building and equipment with a net book value at March 31, 1990, of approximately $1,447,000 is pledged as collateral for outstanding long-term debt.

Maturities of long-term debt during each future fiscal year are as follows: 1991 – $1,021,690; 1992 – $1,009,244; 1993 – $588,614; 1994 – $3,731.

Interest paid approximated interest expense in each of the three years in the period ended March 31, 1990.

NOTE G
SHAREHOLDERS' EQUITY

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, and for shares of the Company's common stock issued and outstanding thereafter. 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, or 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 that the

Company is not the surviving corporation in a merger, or if 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 on July 15, 1998 and may be redeemed at any time prior to becoming exercisable at a price of $.01 per Right.

On September 29, 1989 the Company completed a private placement of 2,142,857 shares of its Senior Series B Convertible Preferred Stock, at $7.00 per share. In the event of liquidation, the Series B holders shall have a liquidation preference over all other shareholders of the Company and be entitled to receive $7.00 per share. Thereafter, all other shareholders would be entitled to receive, on a per share basis, an amount equal to $15 million divided by the total number of shares of common stock that the Series B holders would be entitled to receive upon conversion. Finally, the Series B holders and common shareholders would share ratably in the remainder, if any, with each share of Series B being deemed to have been converted to common stock. Series B holders shall be entitled to vote on all matters submitted to the common shareholders as a single class with the common shareholders, receiving the number of votes equal to the number of common shares that they would have received upon conversion; except that the Series B holders shall be entitled to elect one director and the Company shall need the approval of the majority of the Series B holders on certain significant events.

The Series B holders could originally convert into common stock on a one-for-one basis ("Conversion Ratio"). This Conversion Ratio was originally subject to three adjustments based upon the average market price of the Company's common stock for periods ranging from ten to twenty days after the release of earnings for the fiscal years ending 1990, 1992 and 1993. An adjustment for fiscal 1990 did occur, and the Conversion Ratio is now approximately 1.09, which resulted in an additional 200,000 shares of common stock being issuable upon conversion. The second adjustment, if any, will occur at the end of fiscal 1992 and could result in an increase in the Conversion Ratio of up to .25, which amount will proportionally decrease as the average closing price for the Company's common stock increases from $12.85 per share to $16.51. Finally, the Conversion Ratio shall be adjusted at the end of fiscal 1993 so that the total market value of the common stock in the aggregate that the Series B holders are entitled to receive upon conversion is substantially comparable to the amount originally invested by the Series B holders.

The Senior Series B Convertible Preferred Stock may be redeemed by the Company at $21.00 per share, at any time, provided at least 20% of the then outstanding Senior Series B Convertible Preferred Stock is redeemed. Preferred shareholders shall share ratably in any dividends declared on the common stock, as if each Series B share had been converted to common stock.

Effective March 31, 1989, the Company entered into an exclusive distribution agreement for its products in Latin America with ABS Ventures II Limited Partnership ("ABS"). In conjunction therewith, the Company received $150,000 from ABS for the issuance of certain warrants to purchase the Company's common stock through March 31, 1996. Under these warrants, effective May 22, 1990, ABS can purchase up to 273,438 shares, at a per share exercise price of $6.40. However, the warrant covering 136,719 shares cannot be exercised until March 31, 1992.

As of March 31, 1990, 2,254,718 shares of common stock for issuance under the stock option plans described in Note H and 319,311 shares of common stock for issuance under the Employee Stock Purchase Plan described in Note H were reserved for issuance.

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 in the event of death. At March 31, 1990, options for 713,975 shares were exercisable, and options for 151,931 shares were available for future grants.

A summary of activity in the Plan is presented below:

	Number of Shares	Price of Shares
Outstanding at April 1, 1988	1,159,772	$ .57 – 20.50
Granted	1,291,540	7.38 – 15.63
Exercised	(87,508)	.57 – 14.63
Cancelled	(813,111)	1.13 – 19.38
Outstanding at March 31, 1989	1,550,693	.57 – 19.38
Granted	686,849	6.25 – 9.00
Exercised	(60,342)	.57 – 5.00
Cancelled	(224,413)	4.00 – 19.38
Outstanding at March 31, 1990	1,952,787	$ .57 – $19.38

During fiscal 1989, the Board of Directors and shareholders 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 to 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 cancelled 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 adopted the 1989 Director Stock Option Plan. Under the terms of this Plan, 150,000 shares of common stock have been 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 (beginning one year after the date of grant), at the fair market value of $8.13 on the date of grant and surrendered his or her outstanding option covering 4,500 shares that were issued under the 1983 Stock Option Plan. In future years, each newly elected non-employee director will receive options to purchase 20,000 shares of common stock upon election as director. At March 31, 1990 options for the purchase of 12,000 shares were exercisable under the Director Stock Option Plan. No options have been exercised.

During fiscal 1987, the Company adopted, with shareholder approval, an Employee Stock Purchase Plan whereby eligible employees may invest up to 12% 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. In May 1989, the Board of Directors reserved an additional 400,000 shares for issuance under the Plan, and extended the term of the Plan for an additional two years. The total number of shares reserved under the Plan is limited to 600,000 shares of common stock, of which 280,689 shares were issued in connection with the first five offerings completed during the period November 6, 1987 to November 3, 1989.

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, 1990, 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
1991	$ 8,484,000	$ 322,000
1992	5,688,000	311,000
1993	5,054,000	175,000
1994	1,175,000	136,000
1995	648,000	118,000
Thereafter	251,000	81,000
Total minimum lease payments	$21,300,000	1,143,000
Less amount representing interest		272,167
Present value of net minimum lease payments		$ 870,833

The operating lease minimum payments are based on the Company's existing leases including certain renewal options. The Company is presently negotiating for the lease of certain office space that, if entered into, would eliminate payments under the renewal options as follows: 1991—$2,219,880; 1992—$2,219,880 and 1993—$2,034,890. Under the lease being presently negotiated, minimum lease payments over a ten-year term would be as follows: 1991—$0; 1992—$2,866,500; 1993—$3,185,000; 1994—$3,185,000; 1995—$3,822,000; and thereafter—$21,976,500.

Rent expense amounted to $10,696,928, $8,077,000 and $4,642,000 for the years ended March 31, 1990, 1989 and 1988, respectively.

NOTE J RESTRUCTURING

In fiscal 1990, the Company initiated a significant restructuring of its corporate infrastructure and began a repositioning of its basic business direction. Due to deteriorating sales and profitability of its turnkey systems business, the Company accelerated its transition from being a reseller of workstations manufactured by others, bundled with the Company's software, to a software and specialized services provider, reallocated certain resources to the services component of the Company's business and reduced and/or eliminated assets that were formerly required to support the turnkey systems business of the Company. The restructuring also required that the organization of the Company be streamlined to reflect the shift in the Company's direction.

Specifically, during the third quarter of fiscal 1990, the Company recorded a $13.9 million pre-tax charge to operations relating to its plan of restructuring. Included in this charge to operations were $6 million relating to the elimination of inventory and fixed assets, $5.9 million for the consolidation of the Company's home office facilities and $2 million for employee severance costs. At March 31, 1990, the accrued restructuring charge includes accruals of $1.2 million for fixed-asset disposals, $5 million for reduction of facilities and $537,796 for severance.

NOTE K INCOME TAXES

The Company adopted the provisions of Financial Accounting Standards Board Statement No. 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 were determined to be immaterial.

The provision for income taxes is comprised of the following:

	1990	1989
Current:		
Federal	$288,000	$ 235,000
State	0	68,000
Foreign	(134,000)	165,000
Total current	154,000	468,000
Deferred, principally federal	(464,000)	197,000
	$ (310,000)	$ 665,000

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

	1990	1989
Domestic	$(15,374,632)	$1,131,112
Foreign	(944,270)	397,167
	$(16,318,902)	$1,528,279

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

	1990	1989
Research and development costs, net of amortization	$ (542,000)	$ 547,000
Allowance for uncollectible accounts receivable, vacation and other reserves	(11,000)	(281,000)
Inventory adjustments	(217,000)	(228,000)
Net operating loss and tax credit carryforwards	–	92,000
Excess of tax over financial statement depreciation	235,000	65,000
Restructuring reserve less amounts for which no tax benefit was realized	990,000	–
Other, net	9,000	2,000
	$ 464,000	$ 197,000

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:

	1990	1989
Computed at federal statutory rate of 34%	$ (5,548,000)	$ 520,000
State income taxes, net of federal tax benefit	(130,000)	60,000
Nondeductible amortization	191,000	70,000
Nondeductible travel expense	34,000	42,000
Tax credits	–	(45,000)
Loss for which no tax benefit was realized	5,174,000	–
Other, net	(31,000)	18,000
	$ (310,000)	$ 665,000

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, 1990, the Company has a net operating loss carryforward of approximately $10.5 million that expires in 2005, and approximately $1.5 million of research and development tax credit carryforwards available to reduce future federal income tax liability through 2003.

During 1990 and 1989, the Company made $327,000 and $881,000 in income tax payments, respectively. No income tax payments were made in the year ended March 31, 1988, due to the Company's net operating loss carryforward position.

**[NO]TE L
[IN]DUSTRY SEGMENT, [G]EOGRAPHIC AND [C]USTOMER [IN]FORMATION**

The Company, which operates in a single industry segment, designs, develops and markets systems and software for computer-aided publishing applications.

Information regarding geographic areas at March 31, 1990 and 1989, and for the years then ended is as follows:

March 31, 1990 and for the year then ended	United States	Canada	Europe	Eliminations	Total
Sales to unaffiliated customers	$ 68,820,057	$6,844,769	$13,178,328	–	$ 88,843,154
Intercompany transfers	$ 6,176,268	–	–	$ (6,176,268)	–
Net revenues	$ 74,996,325	$6,844,769	$13,178,328	$ (6,176,268)	$ 88,843,154
Income (loss) from operations	$(14,225,134)	$ (204,517)	$ (599,173)	$ (20,410)	$(15,049,234)
Identifiable assets	$ 65,010,273	$4,081,748	$12,142,123	$ (12,731,856)	$ 68,502,288
Liabilities	$ 17,178,249	$4,168,055	$13,029,386	$ (11,068,417)	$ 23,307,273
March 31, 1989 and for the year then ended					
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	$ 2,560,673	$ (51,583)	$ 403,053	$ (185,467)	$ 2,726,676
Identifiable assets	$ 71,931,316	$5,253,917	$ 4,911,457	$ (8,045,537)	$ 74,051,153
Liabilities	$ 26,131,793	$4,217,546	$ 4,862,823	$ (6,225,247)	$ 28,986,915

Intercompany transfers between geographic areas are accounted for at prices that approximate prices charged to unaffiliated customers. U. S. export sales approximated 8%, 7% and 14% of revenues during fiscal 1990, 1989 and 1988, respectively.

**NOTE M
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 $3.5 million 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 received 97.5% of the revenues from the sale of such products. Under the terms of the agreement, effective April 1, 1990, the Company shall receive 90% of such revenues with the balance being allocated to MLTV. In the quarter in which the joint venture's cumulative profits allocable to MLTV equal or exceed $1.5 million, the Company will have a 30-day option to purchase all of MLTV's rights to the technology for $5.5 million. 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, currently exercisable at $12.33 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 $2.9 million in additional research funds. The Company incurred $800,000 in expenses during the year ended March 31, 1989 ($2.7 million 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 1990 the Company recorded revenues from the sale of joint venture products of $7,069,000 ($7,475,000 in 1989).

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., has provided the Company with $3 million for services that have been completed as of March 31, 1990.

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 made a $50,000 payment to retain its option to purchase PruTech's interest in the joint venture. The Company can now purchase PruTech's interest at 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, effective May 22, 1990, to purchase 290,039 shares of the Company's common stock through October 1995 at $6.40 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.

During the year ended March 31, 1990, the Company received $400,000 in research funds and incurred the same amount of expenses attributable to the research being 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 1990 the Company recorded revenues from the sale of joint venture products of $2,101,000.

NOTE N ACQUISITION

On November 2, 1989, the Company completed its acquisition of Interleaf France S.A., the exclusive distributor of the Company's products in France, Switzerland, Belgium and Luxembourg at a price of $7,055,000. The acquisition was accounted for under the purchase method of accounting. Accordingly, balance sheet accounts of Interleaf France S.A. have been consolidated with those of the Company at March 31, 1990, and the results of operations of Interleaf France S.A. for the five-month period ended March 31, 1990 have been included in the consolidated statement of operations of the Company. The excess of the Company's investment in Interleaf France S.A. at the date of final acquisition, over the fair market value of assets acquired of $4,092,000 and liabilities of $4,725,000 assumed of the company, amounted to approximately $7,688,000 and is being amortized over a period of 25 years.

Had the acquisition occurred at the beginning of 1989, the pro forma unaudited consolidated results of operations would have been as follows:

Year ended March 31	1990	1989
Revenues	$ 92,057,000	$87,354,000
Net income (loss)	$(16,755,000)	127,000
Net income (loss) per share	(1.44)	.01

REPORT OF ERNST & YOUNG, INDEPENDENT AUDITORS

Board of Directors
Interleaf, Inc.

We have audited the accompanying consolidated balance sheets of Interleaf, Inc. and subsidiaries as of March 31, 1990 and 1989, 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, 1990. 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. Those 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, 1990 and 1989, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 1990, in conformity with generally accepted accounting principles.

As discussed in Note K 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 No. 96, *Accounting for Income Taxes.*

Ernst + Young

Boston, Massachusetts
May 4, 1990, except as to
Note G, which date is
May 22, 1990

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1990 and 1989, 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 1990					
Revenues	$22,423,900	$22,005,175	$21,515,954	$22,898,125	$88,843,154
Net income (loss)	125,628	(968,490)	(15,315,821)	149,781	(16,008,902)
Net income (loss) per share	.01	(.08)	(1.31)	.01	(1.37)
Common stock prices					
High	9 5/8	8 1/8	7 1/8	7 3/8	9 5/8
Low	7 3/4	6 7/8	5 3/4	5 1/2	5 1/2
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

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 loss per share for the quarter ended December 31, 1989 has been restated from the amount previously reported due to a decrease in the number of shares used in computing net loss per share.

The Company's common stock has been traded on the NASDAQ National Market System since its initial public offering in June 1986. On May 7, 1990, there were 1,230 holders of record of the Company's common stock.

SELECTED FIVE-YEAR FINANCIAL DATA

Year ended March 31	1990	1989	1988	1987	1986
For the year					
Total operating revenues	$88,843,154	$82,780,181	$58,388,721	$37,173,162	$18,645,883
Net income (loss)	(16,008,902)	863,279	6,979,897	(410,121)	(2,443,401)
Net income (loss) per share	(1.37)	.07	.59	(.04)	(.29)
At year end					
Total assets	68,502,288	74,051,153	61,762,464	44,734,377	18,676,887
Long-term obligations	1,912,333	13,246,381	4,812,939	1,362,892	1,901,608
Total shareholders' equity	45,195,015	45,064,238	42,992,655	35,290,459	11,020,251

CORPORATE AND OTHER OFFICERS

William W. Barnes*
Vice President of Human Resources

Lawrence S. Bohn*
Vice President of Business Development

David A. Boucher*
Chief Executive Officer and Chairman

David J. Collard*
Senior Vice President of Finance and Administration and Chief Financial Officer

David L. Cross*
Treasurer

Stephen J. Cummings*
Vice President of International Operations

Frederick J. Egan*
Vice President of Corporate Relations

Robert A. Fisher*
Vice President of Customer Support

John K. Hyvnar*
General Counsel

Dianne E. Jenett
Regional Sales Vice President

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

James M. Meyer*
Vice President of Systems Integration

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

Mark K. Ruport*
Senior Vice President of Worldwide Sales

Laura K. Scarbro
Vice President of Workstation Engineering

Steven M. Schwartz*
Vice President of Marketing

Matthew Szulik
Regional Sales Vice President

Ellen W. Taylor*
Vice President of Product Marketing

Andrew J. Van Abs*
Vice President of Engineering Solutions

Robert K. Weiler*
President and Chief Operating Officer

*Corporate Officer

BOARD OF DIRECTORS

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General Partner
Applied Technology Partners

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Interleaf, Inc.

Harry A. George
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Dr. Michael Hammer
President
Hammer & Company, Inc.

Daniel Harari
Directeur Général
Compagnie Financière du Scribe

Clinton P. Harris
Senior Vice President
Advent International Corp.

George D. Potter, Jr.
Vice President of Marketing
GESCAN International, Inc.

Patrick J. Sansonetti
Senior Vice President and Partner
Advent International Corporation

Robert K. Weiler
President and Chief Operating Officer
Interleaf, Inc.

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 10, 1990 at 9 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 02102–0644.

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

Independent Auditors
Ernst & Young
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

Sales Offices

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

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

International
Adelaide, Canberra, Melbourne, Sydney, Australia; Brussels, Belgium; Paris, France; Hong Kong; Milan, Rome, Italy; Hoofddorp, The Netherlands; Zurich, Switzerland; Stockholm, Sweden; Richmond, Manchester, U.K.; Dusseldorf, Frankfurt, Hamburg, Munich, Stuttgart, West Germany

ABOUT THIS ANNUAL REPORT

This annual report was created by Interleaf's Corporate Design Group with Interleaf software. Text and financial information were entered by people in various departments throughout the Company and transferred electronically to the Design Group. To make the illustrations, drawings rendered with Interleaf's on-line drawing tools were combined with screen captures, scanned photographs and scanned tonal patterns. Files were sent to a typesetter for final output of camera-ready pages.

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