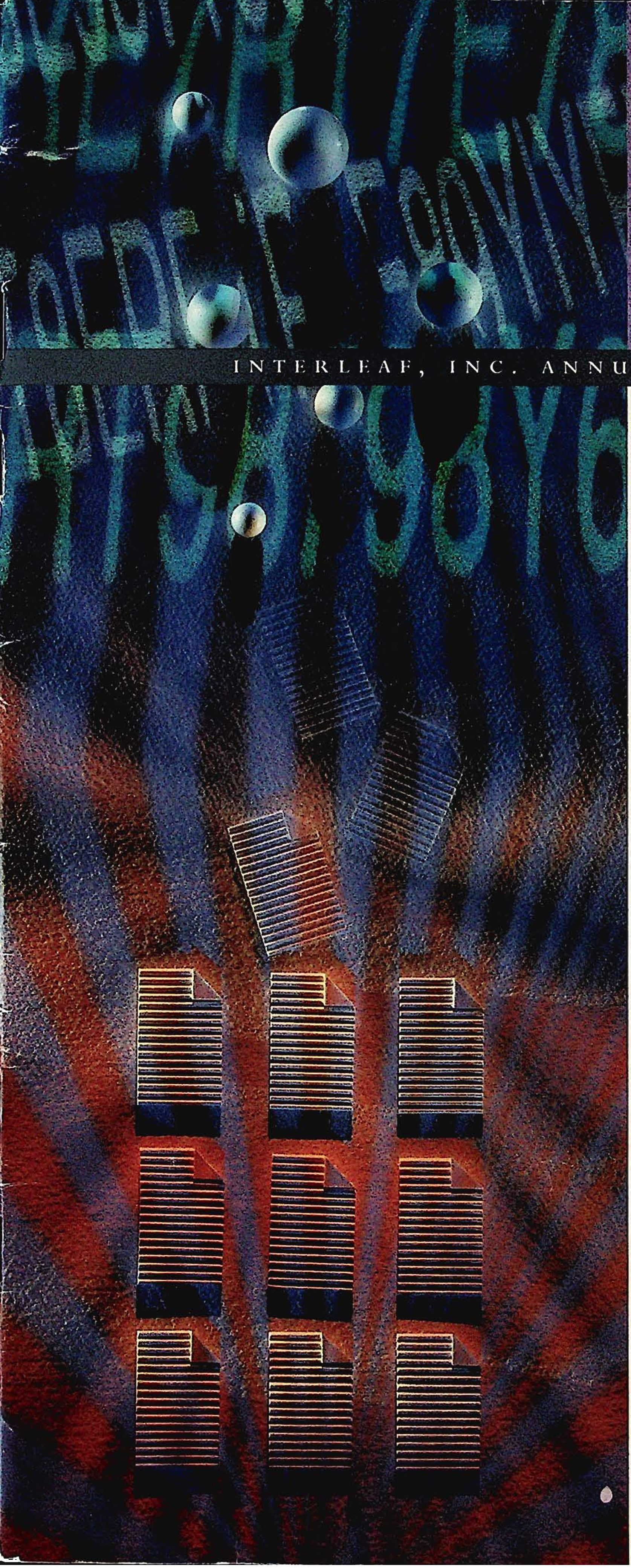
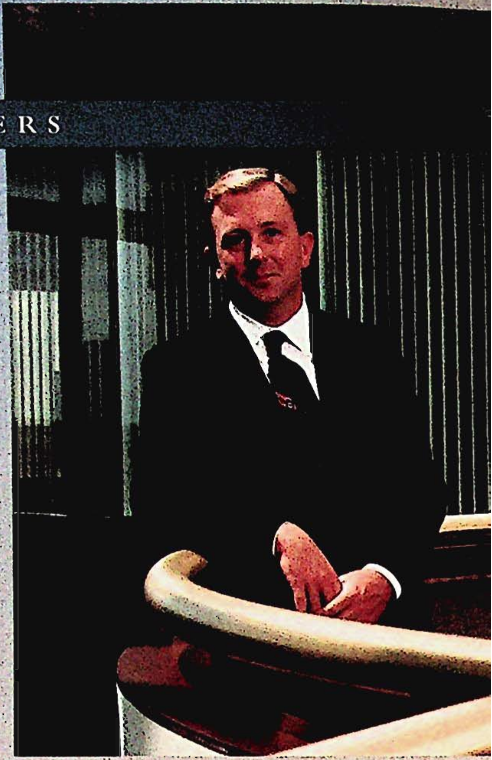
Interleaf



INTERLEAF, INC. ANNUAL REPORT 1994

TO OUR SHAREHOLDERS



Interleaf is the leading worldwide supplier of open, integrated document management systems. With the industry's only complete solution, we enable organizations to gain competitive advantage by leveraging their valuable investments in information, computer systems and people. We do this by combining software and services that help organizations automate the business-critical processes that rely on documents.

Interleaf, Inc.
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Waltham
Massachusetts
02154

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FAX 617.290.4943

Interleaf

Mark K. Ruport
President &
Chief Executive Officer

Achieving growth in the emerging document management market is not a short-term effort. It has required above-average investment to demonstrate to organizations the strategic value and benefits that document management systems offer. Our fiscal 1994 results reflect that investment.

We closed this fiscal year on an upward trend despite lower-than-expected sales of $111 million. The loss incurred this fiscal year included $7 million in one-time costs related to our acquisition of Avalanche Development Company and to restructuring our operations.

I feel a sense of disappointment in not meeting our goals, but I also have a sense of renewed confidence in positioning Interleaf in the forefront of one of the fastest-growing markets of the '90s – the integrated document management market.

This fiscal year, we expanded the number of markets and industries which we serve. We strengthened our foothold in Japan and expect continued growth in this market. We continue to strengthen our market position in Europe despite the weak European economies which severely affected our 1994 performance. And we are especially pleased with Interleaf's rapid expansion in industries such as biotechnology, financial services and telecommunications.

To lead us into these new industries, we invested heavily in our product strategy. We developed Intellecte, the industry's first fully integrated document management solution that addresses the market's need for a cost-effective and timely approach to implementing document management systems. We acquired Avalanche and are leveraging its SGML technology across our entire product suite to strategically position Interleaf as SGML becomes the worldwide standard for information interchange and reuse. Our new version of WorldView promises to further strengthen our dominance in the electronic document distribution market. With the introduction of Interleaf 6 for Windows and Windows NT, we are adding to our Window-based product set and broadening our technology's appeal to PC users.

As the market's understanding of the benefits of document management grows and as we deliver the highest-quality products and services in the industry, we believe we will accelerate our growth. I look forward to reporting this news to you.

Mark K. Ruport

Interleaf Strategy Designed to Capture Market

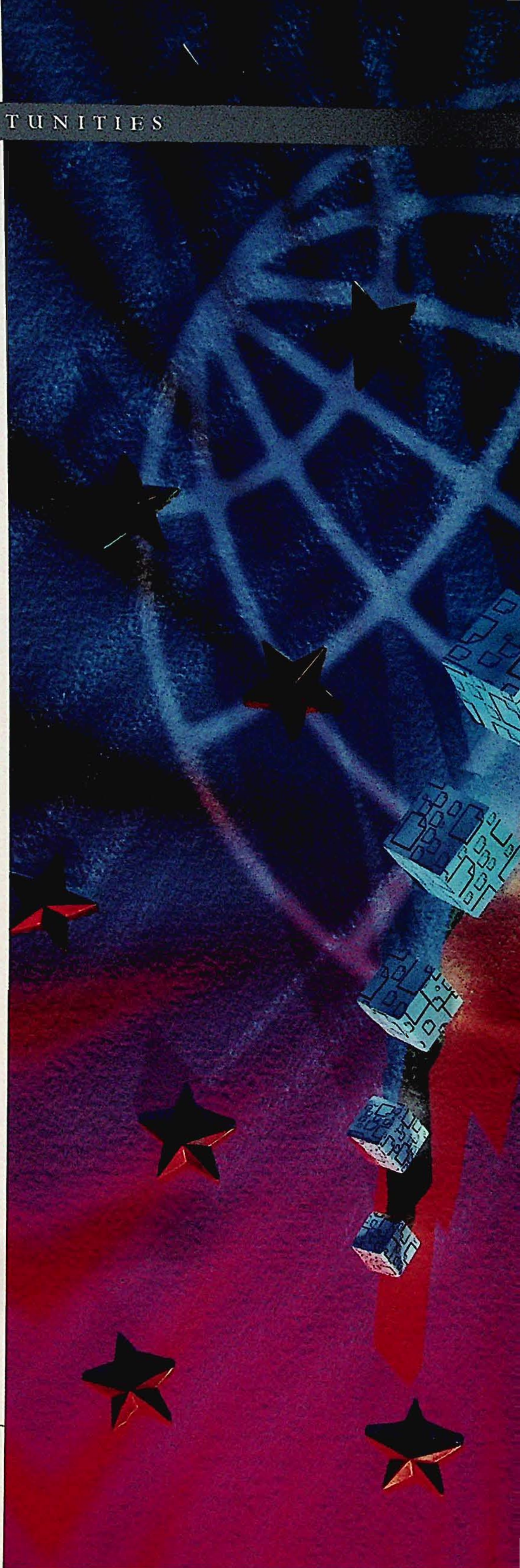
Recent market research by International Data Corporation shows that the document management market will quadruple to $4 billion by 1998. Two main factors are spurring this market acceleration: an increased awareness of document management issues and increased global pressures for standards.

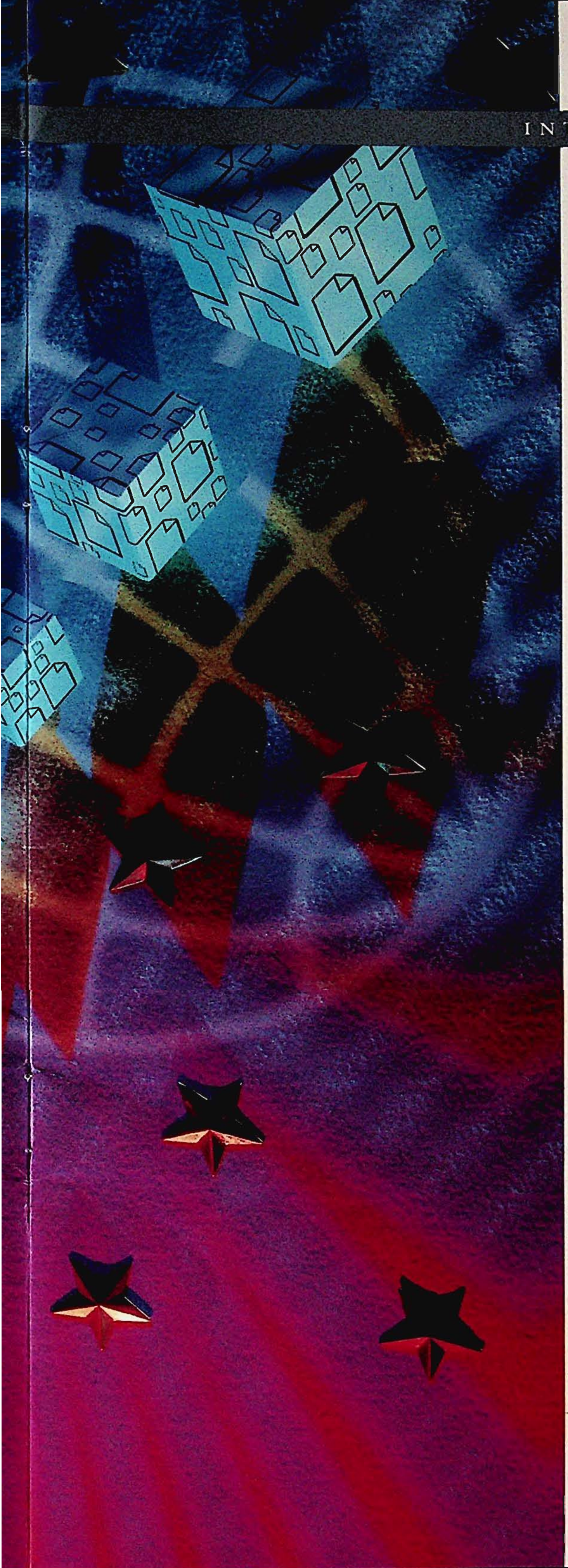
Despite investments in reengineering, organizations still face a fundamental challenge – how to access, share and reuse their business-critical information. Because they are finding that the majority of that information is in documents, organizations are increasingly using document management as the next step in improving information management.

The worldwide adoption of the International Standards Organization's quality control guidelines, ISO 9000, is also putting heavy pressure on organizations. ISO compliance has become a major criterion in doing business in Europe and Japan. Under ISO 9000, manufacturers must document every step in their manufacturing and development processes to prove the quality of their products. While this ensures consistency across vendors and countries, it greatly intensifies the need for document management.

These developments open whole new industries and provide substantial opportunities for Interleaf. We have been building our technology and designing our products in anticipation of these trends. Our product suite addresses the entire information lifecycle. Our technology is object- and client/server-based to ensure powerful information sharing, reuse and management across an organization. An open architecture and commitment to SGML ensure unencumbered information interchange across different computers, organizations and countries. We provide complete flexibility, so organizations can extend and tailor our products as their business objectives evolve. These are the keys to Interleaf's leadership position in the document management market and to our ability to capture growing market opportunities successfully.

Increased understanding of document management and increased global pressures for more "documentation" continue to create substantial opportunities for Interleaf.





The Fast Path to Document Management

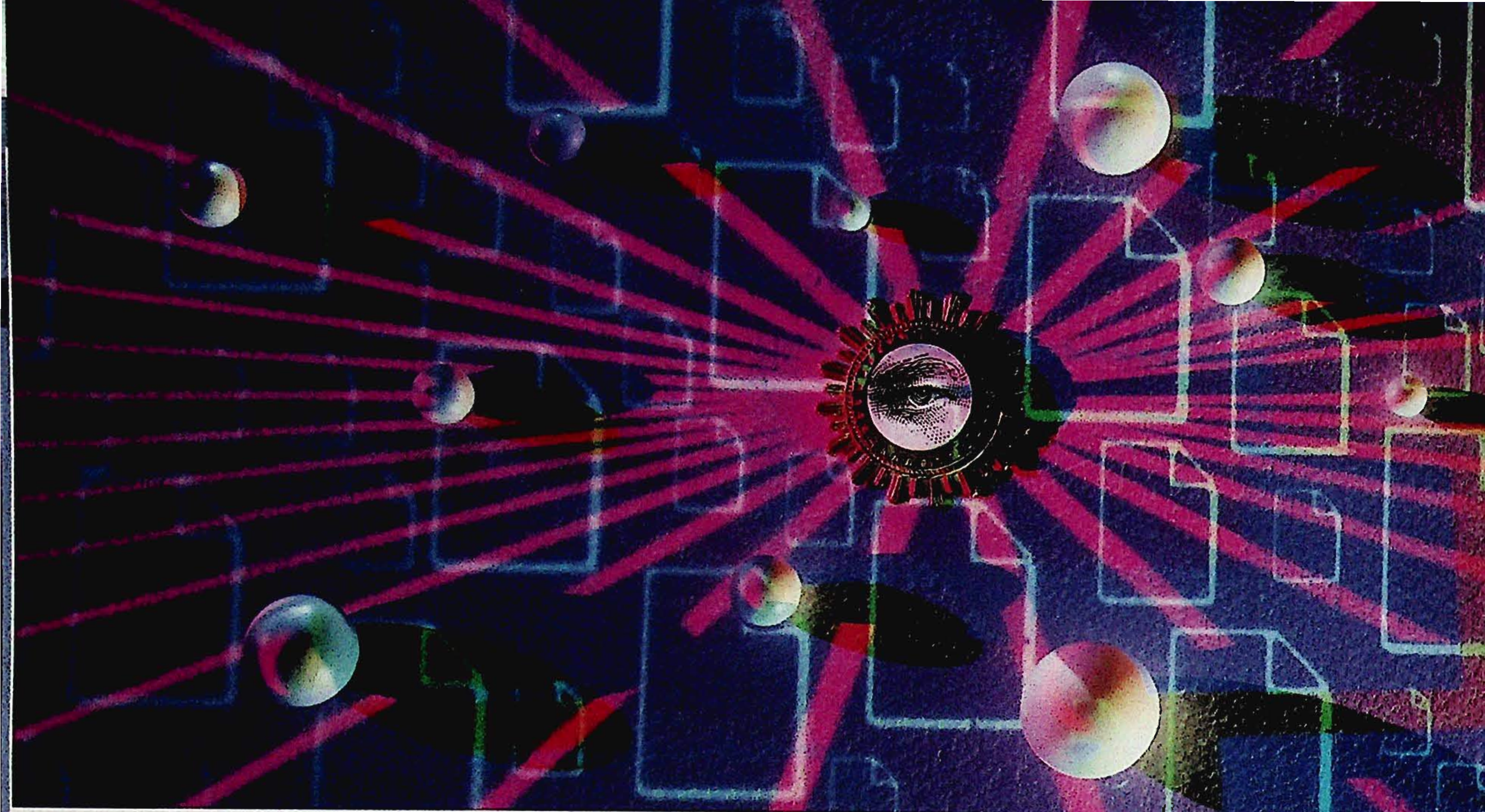
The most important issues for organizations in search of document management solutions are: access to and reusability of information. Many organizations, however, are finding that implementing a document management solution across an organization can be a costly, time-consuming and risky endeavor.

With Interleaf Intellecte, our integrated document management solution, we are making it easy for organizations to implement document management systems. International Data Corporation said in a recent report: "Interleaf Intellecte is a unique entry into the document management market. In addition to providing a foundation of products aimed at managing the document lifecycle for document-critical applications, Interleaf Intellecte also leverages Interleaf's many years of experience in customizing document publishing solutions."

Intellecte combines our technologies – electronic document viewing and distribution; secure, central document repository; automated workflow management; and optional automated document assembly – with expert services and proven implementation methodology. Our multi-phase, flat-fee strategy enables organizations to successfully implement an integrated document management application in a cost-effective way. At the end of 12 weeks, users can "point and click" to access information in a set of key documents. By participating in the design and implementation of their applications, organizations acquire the confidence and skills to replicate the solution for other business processes throughout the enterprise.

This, we believe, is what the market is demanding – a quick, easy and risk-free way to implement a document management solution. And only Interleaf offers such an approach.

Interleaf Intellecte, the industry's only integrated document management solution, is a direct response to market demands for an easy, timely and risk-free way to gain competitive advantages through document management.



Something as elementary as quick and easy access to information can bring competitive advantages to organizations. WorldView offers tools for distributing document collections on any system so people can simply point and click to find what they need.

Leveraging Knowledge Around the World

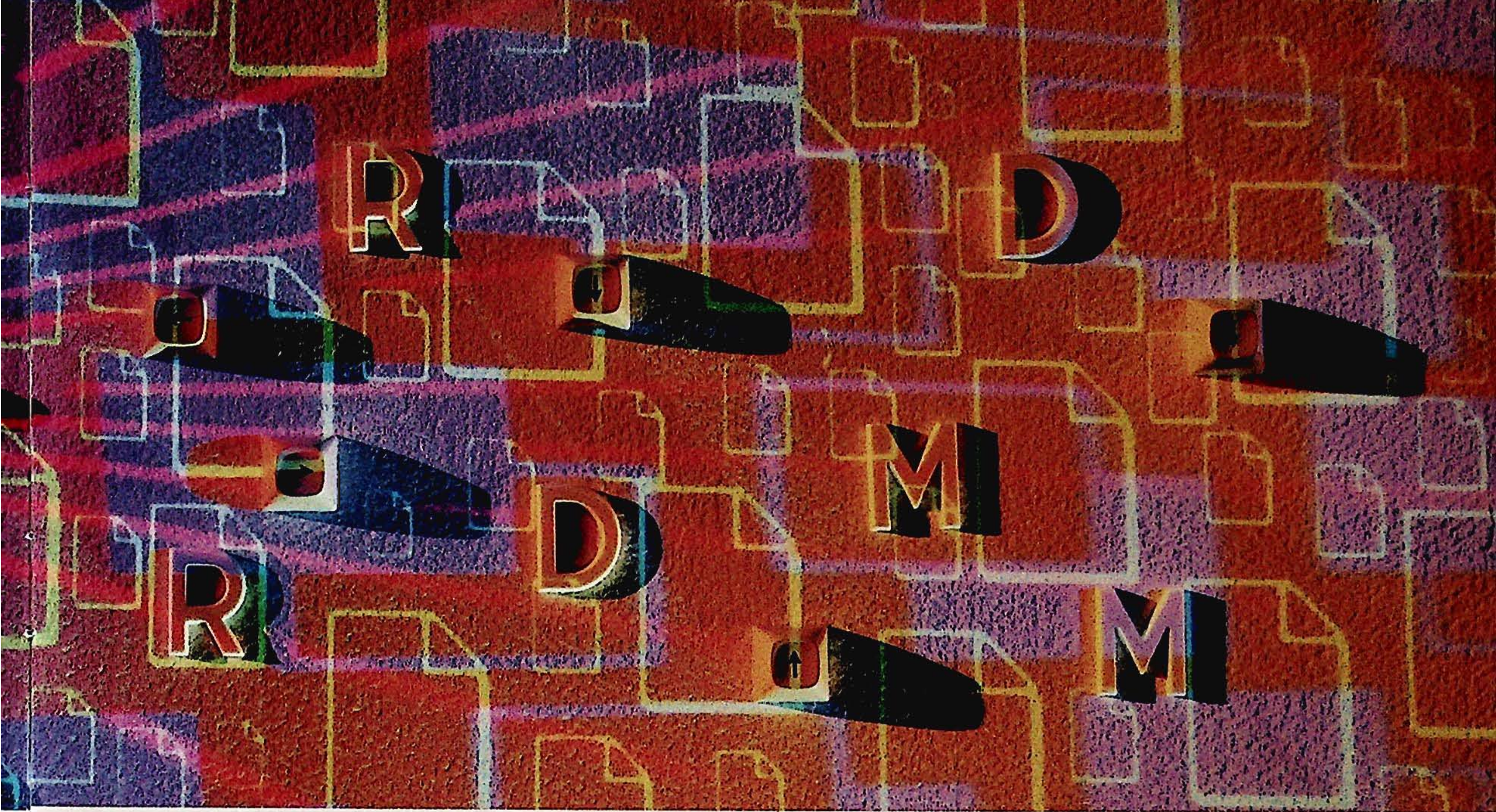
Interleaf WorldView is a best seller. Sales reached $14 million and the number of installed copies reached the one million mark this year.

WorldView is uniquely positioned in the rapidly growing electronic distribution market. While competitors are in various stages of formulating a strategy for electronic document distribution and viewing technology, WorldView has cornered the market for over three years. Today, it is the most comprehensive solution in the industry.

Organizations can build a collection of business-critical files, add intelligence and links to that collection, then distribute this newly formed knowledge base within any environment from mainframes to laptops. Users achieve higher productivity through immediate and easy access to information, while the organization increases the volume of and improves the accuracy of the information it distributes, all at lower costs. The latest version of WorldView supports structured documents, moving the product closer to our SGML, open information access strategy.

Interleaf, as a company, is also benefitting from WorldView's versatility and power. For a few years now, we have been providing WorldView-based online product documentation and online multimedia tutorials. This year, we implemented a wide-area-network repository from which our worldwide offices can quickly access important sales, consulting and marketing documents. This is enabling us to accelerate and enhance our sales efforts.

We are also using WorldView technology to improve communication with our customers. For instance, customer support is available through a "Personal help Desk" (PhD) on CD, and ordering products from Interleaf is now easier with our CD-based telemarketing catalog. Like our customers, we continue to explore and find new applications that tap WorldView's full potential.



Information accuracy and reusability are keys to successful document-intensive business processes. Interleaf RDM controls all types of objects — from documents and data to video and audio files — throughout their lifecycles from access to assembly to revisions.

RDM

Controlling Enterprise Knowledge Bases

According to industry analysts, Interleaf RDM is the leading product for controlling business-critical information in environments that have different applications, hardware and operating systems. As the central technology in the Intellecte solution, we expect RDM to gain even greater market share.

RDM manages objects: text, graphics, images, documents, video files, database data. And it does so throughout the objects' lifecycles, from configuration to access to routing and tracking versions during review cycles. Powerful library management tools enable organizations to build online knowledge bases from which users can share and reuse timely, accurate information. RDM is capable of managing information "bills of materials" that it can deliver to any application, particularly to document composition applications such as Microsoft Word or Interleaf 6, and/or to an online delivery application such as WorldView.

We designed RDM with the greatest amount of openness possible. A distributed architecture means it can manage information from virtually any software application over a worldwide network. Like all our products, RDM is available in multiple languages including French, German and Japanese. As the ISO 9000 guidelines gain worldwide support, RDM plays a crucial role in organizations' ability to control, track and manage the myriad of quality-related documents. And, befitting our structured document strategy, RDM also supports SGML objects.

While many customers use RDM's off-the-shelf functionality, others employ its easy-to-use Application Programming Interface (API) tools to tailor the functionality or to integrate it into existing systems.

Leveraging Information Through Electronic Documents

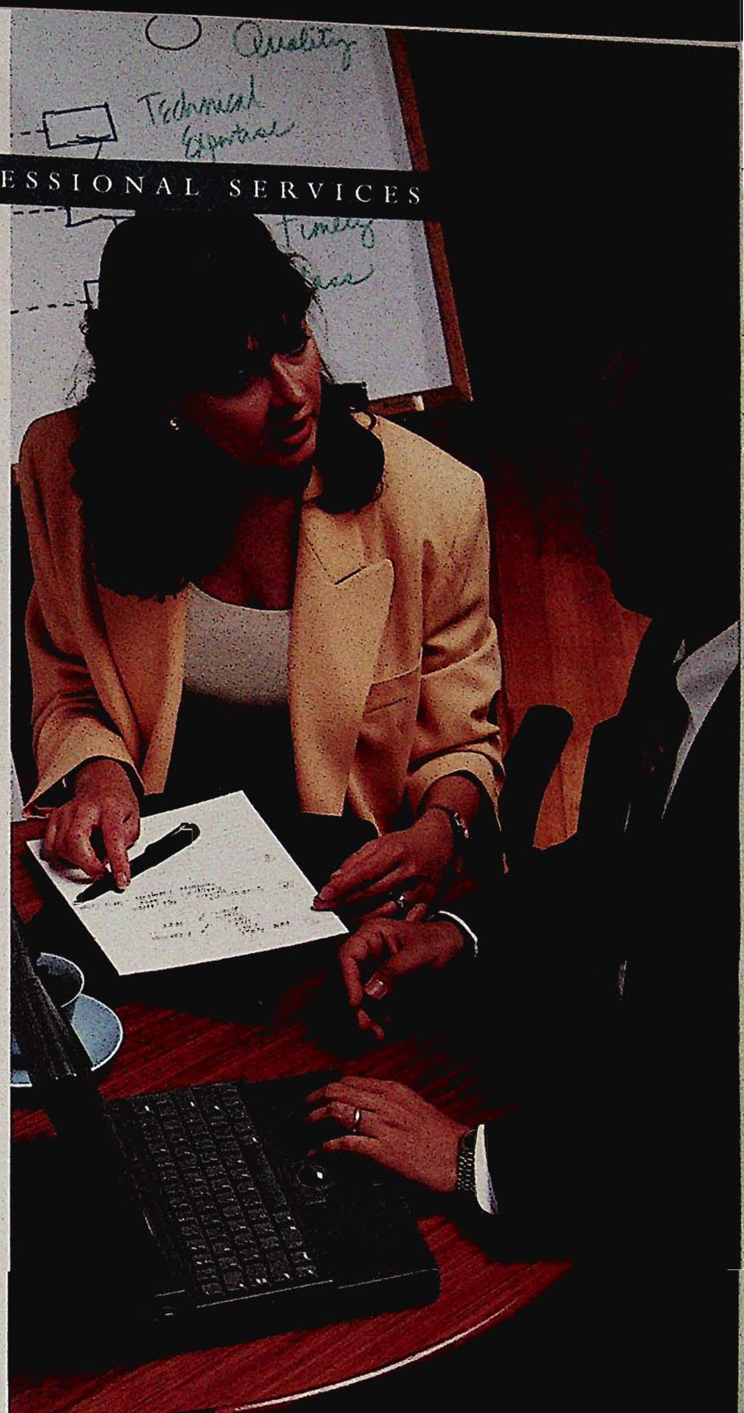
"Interleaf 6 is unlike conventional DTP (desktop publishing) software . . . Its emphasis on distributing publishing processes in a networked environment . . . makes it even more powerful. And its robust interfaces to programming languages give Interleaf 6 far more flexibility," said *PC Magazine* in its May 17, 1994 issue.

As a next-generation document creation, composition and assembly product for workgroups, Interleaf 6 provides ease-of-use through support for major graphical user interfaces such as Motif.

Unlike other products in its category, Interleaf 6 is also a powerful publishing engine, providing document project managers with the ability to manage concurrent, multi-volume, multi-author, multi-application projects. For systems managers, Interleaf offers ready-to-use programming tools to automate, customize and reengineer workflow processes. Support for SGML in Interleaf 6 takes our commitment to open systems one step further, by providing an intelligent editor that ensures that documents adhere to standard structure and are ready for reuse in other applications.

With Interleaf 6 for Windows and Windows NT shipping in fiscal year 1995, we are completing our Windows offering across all our products and bringing Interleaf 6 document creation power to an even broader market.

The document, in print or in electronic form, is the most effective medium for conveying information. Interleaf 6 takes the toil out of assembling documents and managing the publishing process so organizations can produce business-critical documents on time and on specification.



World-Class Services and Support

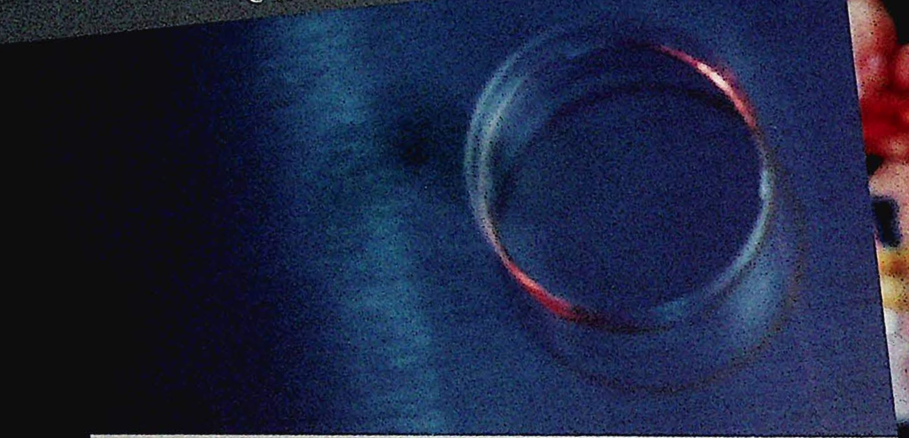
The methodology we employ with our Intellecte solution is the result of over 12 years of experience in helping organizations build document management systems. While Intellecte implements an integrated document management solution for one business process at a time, the Interleaf Professional Services Group of more than 250 technical and industry consultants works with our customers to achieve a wide range of business objectives, from high-level customization and integration to automating and reengineering business processes.

For the second year in a row, Interleaf took first-place honors in the Desktop Publishing Software Product Report in *VARBusiness*, the leading industry publication for value-added resellers. VARs singled out Interleaf not only for our products' extensibility and for the high quality of our online viewing technology, but also for our world-class technical support. With an average of nine years of software applications and operating systems experience, each Interleaf support engineer brings a wealth of expertise to every call. In addition to real-time call response, we also offer a 24-hour knowledge base over the Internet so our customers can access technical information around the clock. This knowledge base is also available on CD.

Along with professional services and technical support, our training programs help customers optimize their Interleaf investment. We provide them with hands-on training for the entire range of Interleaf capabilities, from book building to customizing and extending Interleaf functionality. Courses are available in training centers around the world and at customer sites. We also work with customers to develop courses that are tailored to meet their specific requirements and goals.

Forming partnerships with our customers ensures that they can leverage and benefit from our worldwide staff and from our 12 years of experience. In turn, we continue to gain understanding of the challenges our customers face so we can better respond to their needs.

CELL THERAPEUTICS, INCORPORATED



CTI

CELL THERAPEUTICS, INC.

201 Elliott Avenue West
Suite 400
Seattle, Washington 98119
Telephone 206 282 7100
Facsimile 206 284 6206

"Retrofitting is costly. Because information is part of our competitive strategy, we are engineering our entire information infrastructure right from the start and Interleaf is a major component of our strategy."

M S Arnold

Michael Arnold
Vice President, Information Systems and Treasury Operations
Cell Therapeutics, Incorporated

For millions of cancer patients, treatment can be just as debilitating as the disease itself. Cell Therapeutics, Incorporated (CTI) is the developer of lisofylline, a compound that is proving effective in limiting the toxic side-effects of cancer treatments. Lisofylline is the first of several compounds that CTI is developing.

While many larger companies are facing the challenges of cumbersome information infrastructures that are requiring costly reengineering, CTI is carefully building an open information infrastructure that will be a success at inception and for years to come.

With Interleaf Intellecte, CTI is automating the management of the clinical trial report process – from data collection and report consolidation to review-cycle distribution and workflow management. Then the company is expanding and applying this solution to other new drug application (NDA) processes, eventually delivering an electronic NDA or CANDA (Computer-Aided New Drug Application).

"We chose Interleaf as one of the company's core technologies because it is robust and can handle the demands of the information-intensive testing and NDA processes. It integrates into our mixed-application environment and offers us the flexibility to map technology to our growing and evolving information requirements," says Michael Arnold, Vice President of Information Systems and Treasury Operations at CTI.

ALCATEL
BUSINESS SYSTEMS

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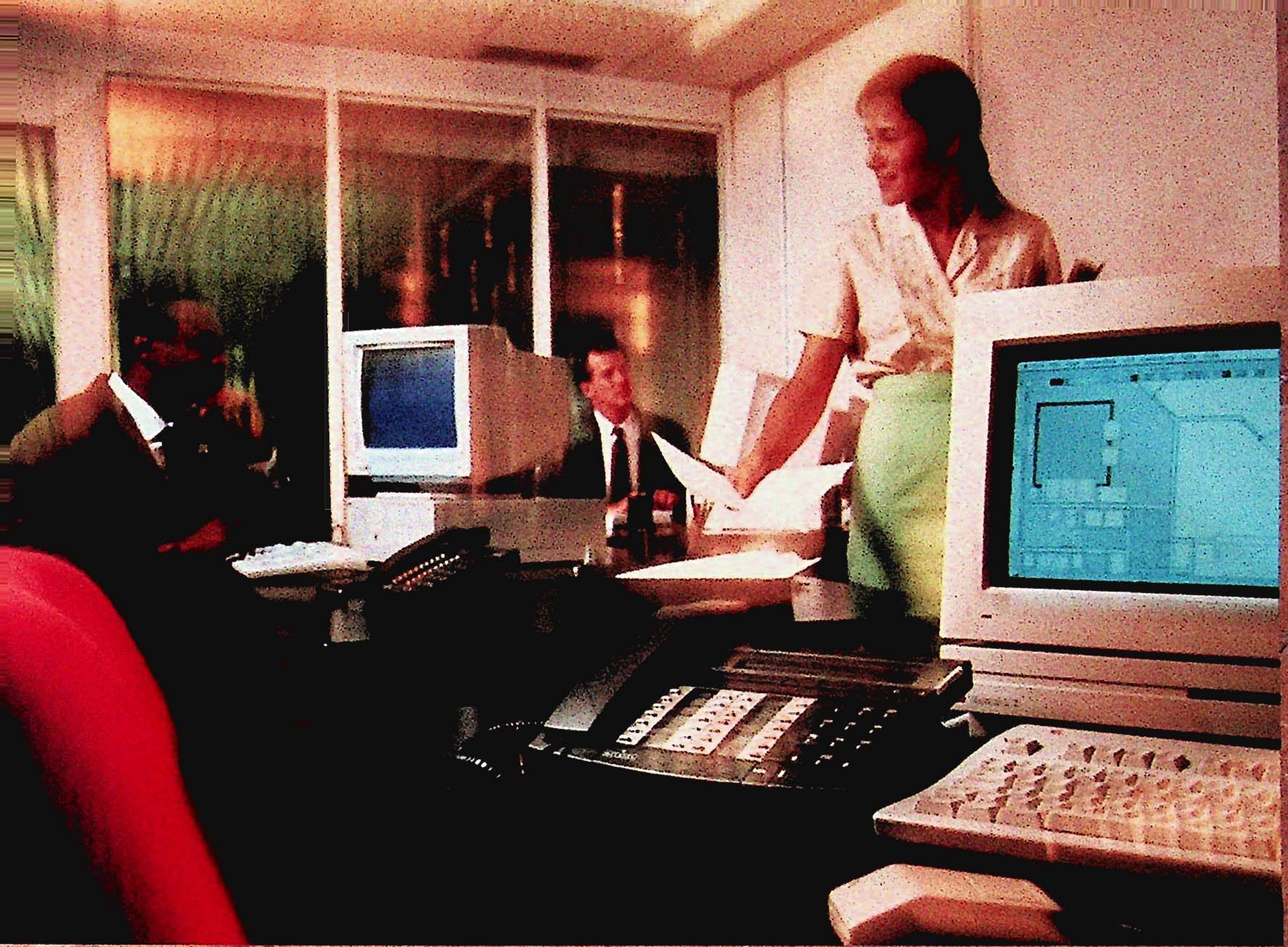
92707 Colombes Cedex
France
Tél. : 33 + (1) 47.69.47.69
Télécopie : 33 + (1) 47.69.49.99

"While our customers are dependent on our technology for their competitive advantage, our competitive advantage is dependent on our ability to respond effectively to them. That translates to having timely access to accurate information, particularly in the field."

Frédéric Pinot
Directeur Général
Alcatel Business Systems France

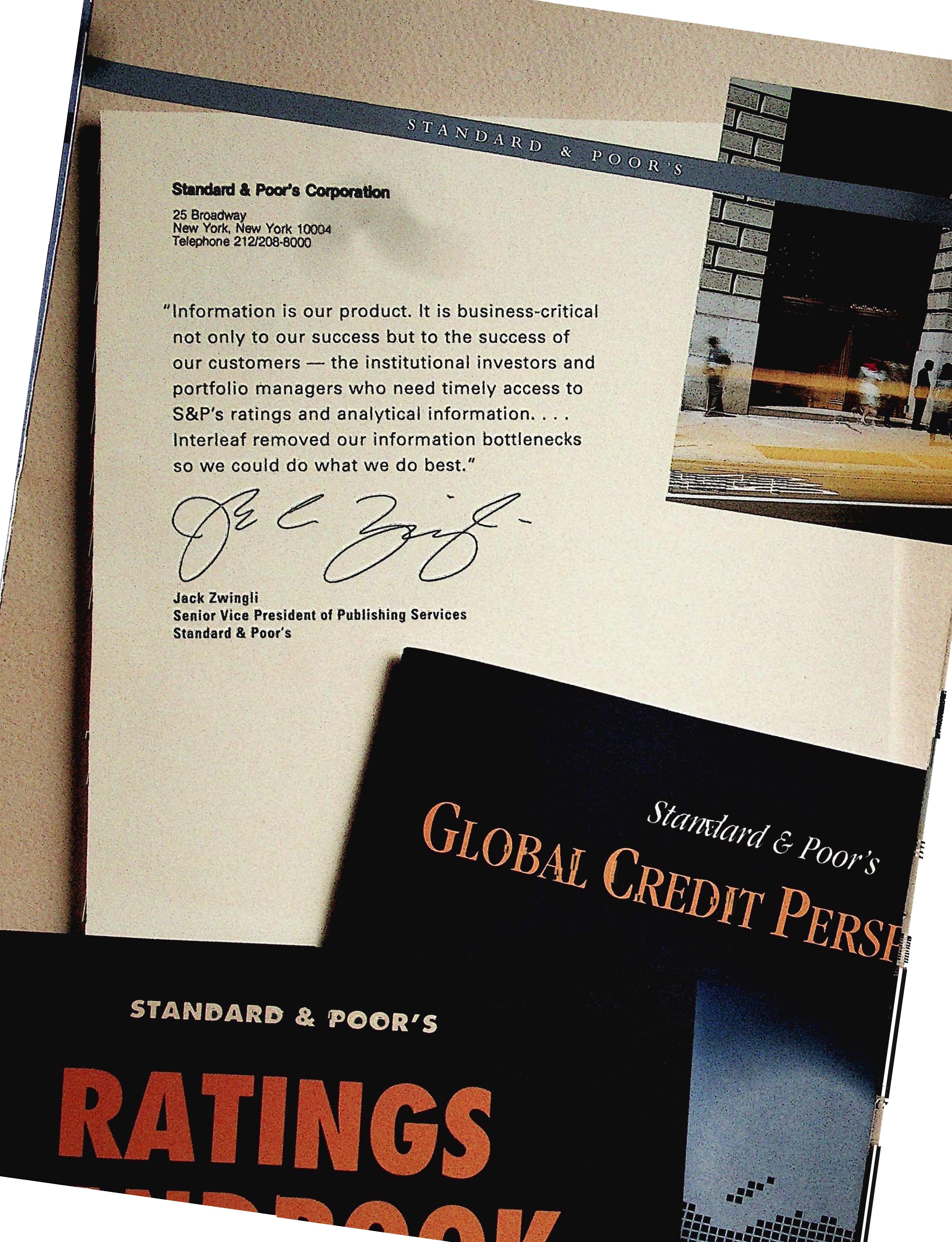


Telecommunication systems have become the lifeline of today's business communications and transactions. Alcatel Business Systems, a subsidiary of Alcatel, the world's largest supplier of comunications systems, manufactures advanced switchboard systems for companies worldwide. There are multiple variations of each system, and each variation requires substantial installation and maintenance information. Alcatel Business Systems used 60 to 120 tons of paper per year to distribute that information. That was enough documentation to fill field engineers' vans to capacity. Searching for information was difficult, and there was no guarantee that it was the latest version.

Now with Interleaf, when Alcatel Business Systems engineers service their customer sites, they simply type a word or phrase on their PC-, Macintosh- or UNIX-based laptops to have instant access to all of the information they need.

"Interleaf electronic information distribution technology has proven to be less expensive, more efficient and very flexible. And with more current and accurate information, we're able to enhance the quality of our services and to promote our company's image as the world's leading communications specialists," adds Frédéric Pinot, Directeur Général of Alcatel Business Systems.

Alcatel Business Systems is just one of the many companies in which Alcatel has introduced and implemented Interleaf document management solutions. Over the next few years, Alcatel companies worldwide will develop, distribute, store and manage document-based information in various environments including engineering, using Interleaf technology. Interleaf will also be at the heart of Alcatel's worldwide electronic knowledge base.


STANDARD & POOR'S
Standard & Poor's Corporation
25 Broadway
New York, New York 10004
Telephone 212/208-8000
"Information is our product. It is business-critical not only to our success but to the success of our customers — the institutional investors and portfolio managers who need timely access to S&P's ratings and analytical information. . . . Interleaf removed our information bottlenecks so we could do what we do best."
Jack Zwingli
Senior Vice President of Publishing Services
Standard & Poor's
Standard & Poor's
GLOBAL CREDIT PERSP
STANDARD & POOR'S
RATINGS

When the world's leading investment rating firm decided to streamline its information workflow, it called upon Interleaf. Standard & Poor's (S&P), a division of McGraw-Hill, has analysts monitoring municipal bond markets around the world. Any change in these sectors sets S&P's information exchange mechanisms whirring — an analyst in Paris may need data from an office in Tokyo, a flowchart from New York or a table from London. Faxes, electronic mail and telephones helped the organization circulate and search for information worldwide. Unfortunately, once the right information was found, analysts had to re-create it for inclusion in new documents such as press briefs, analyses and reports.

As S&P's document management engine, Interleaf manages the entire workflow, from handling information access to routing electronic review copies and tracking multiple versions. Analysts extract information directly into their Word document from the Interleaf RDM repository. When their documents are ready for review, Interleaf WorldView distributes them to reviewers. Once approved, the Publishing Services staff tags information to be placed back into the repository for future reuse.

"We cannot afford to have our analysts bogged down by a publishing and review process that forces them to spend hours hunting for information; their value is in ensuring the analytical quality of S&P's ratings," says Jack Zwingli, Standard & Poor's Senior Vice President of Publishing Services.

"The Interleaf document management solution is flexible, allowing us to integrate with existing resources such as Microsoft Word and Excel, Xerox Ventura, and Lotus cc:Mail, and to weave it seamlessly into the way the analysts work," adds Mr. Zwingli.

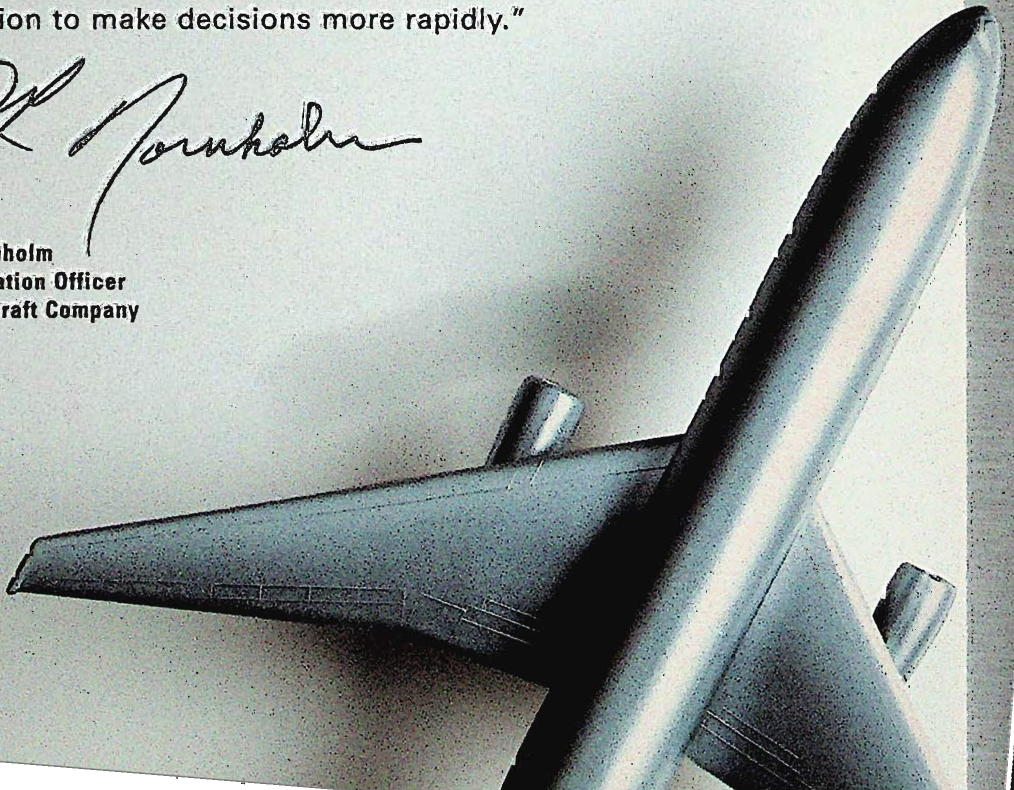
DOUGLAS AIRCRAFT COMPANY

DOUGLAS AIRCRAFT COMPANY

3855 Lakewood Boulevard Long Beach, California 90846
TWX: 9103416842
Telex: 674357

"Making sound decisions is a key step toward competitiveness. Building Interleaf technology into our information processes is enabling our organization to make decisions more rapidly."

Pauline Nornholm
Chief Information Officer
Douglas Aircraft Company



For the Douglas Aircraft Company's (DAC) IS group, bringing the best-value products to the highly competitive transport aircraft market means enabling people in the organization to access the right information easily and in real-time. In analyzing their business-critical information processes, DAC CIO Pauline Nornholm and her team found that these processes are tightly intertwined with the document process.

DAC chose Interleaf as the core technology for its document management solution. Because Interleaf has an open, flexible and adaptable system architecture, it fits into DAC's diverse client-server environment, allowing the company to leverage its existing infrastructure while preparing for the future.

Using Interleaf's expertise, technology and implementation methodology, Ms. Nornholm's organization successfully brought many manufacturing processes online, including instructions, policies and procedures. Shop floor technicians now point and click for instant access to information from a dynamic repository, which also tracks the information throughout its lifecycle and ensures that it is timely and accurate. DAC anticipates a cost savings of half a million dollars as early as one year from this initial implementation.

"More than cost savings, Interleaf has given us the know-how to build similar solutions across our enterprise," says Ms. Nornholm.

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 consideration of the Company's internal control structure to determine the auditing procedures required to support their opinion on the consolidated financial statements.

Mark K. Ruport
President and Chief Executive Officer

Richard P. Delio
Chief Financial Officer

Report of Audit Committee Chairman

The Audit Committee of the Board of Directors is composed of three independent directors. The Committee held five (5) meetings during fiscal 1994. 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 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 on any auditing matters.

Frederick B. Bamber
Chairman, Audit Committee

Year ended March 31	1994	1993	1992
Revenues	100 %	100 %	100 %
Costs and expenses:			
Cost of products, maintenance and services sold	30	25	24
Selling, general and administrative	53	47	50
Research and development	16	14	15
Amortization of software and development costs	3	3	3
Restructuring charge	3	–	–
Charge for purchased research and development	3	–	–
Total operating costs and expenses	108	89	92
Income (loss) from operations	(8)	11	8
Interest income (expenses), net	–	–	–
Other expense	(1)	(1)	(1)
Income (loss) before income taxes	(9)	10	7
Provision for income taxes/change in accounting principle	1	2	1
Net income (loss)	(8) %	8 %	6 %

Results of Operation

In fiscal 1994 Interleaf incurred a net loss of approximately $8.45 million on total revenue of approximately $111 million. Approximately $4 million of this loss was attributable to its June 1993 cash acquisition of Avalanche Development Company, a leading developer of structured authoring technology ("SGML"), which resulted in a charge to operations for acquired research and development. These results were significantly lower than the Company's operating performance both in fiscal 1993, when the Company recorded net income of approximately $9.3 million on revenue of approximately $117 million, and in fiscal 1992, when the Company recorded net income of approximately $6 million on revenue of $100 million.

In fiscal 1994, the Company expected faster growth in the global market for integrated document management solutions. The Company's strategy was to use its structured creation product, Interleaf 5, its electronic distribution product, WorldView, and its document management product, RDM, to develop a total document management system that would allow the Company to more effectively compete against smaller firms who had the ability to provide only one particular component and not a total integrated system.

During fiscal 1994, the Company realized that its customers and discrete workgroups within these customers were at different and various stages of understanding and implementing their document information systems, and that purchases were often being made for specific tasks on a piecemeal basis. As a result, the Company's principal competitive advantage of being able to offer an integrated document management solution has not yet been fully realized. Moreover, the Company recognized that market acceptance of document-based information systems differs significantly by geographic area. In the United States, which accounted for approximately 61% of the Company's revenue in fiscal 1994, market demand, while highly competitive, is growing. In Europe, which accounts for approximately 30% of the Company's revenue, market demand is just beginning to develop, while Asia, which accounts for approximately 5% of total revenues, is in the early stages of document management. The Company understands that it will have to compete on a product-by-product basis until this market further develops, and that it needs to better market the advantages of acquiring an integrated document management system provided by a single developer. The Company expects that its February 1994 announcement of Intellecte™, its integrated document management solution which combines creation, viewing, and management into one package, with expert services, will underscore this advantage.

REVENUE CHANGES BY GEOGRAPHIC AREA

Domestic: Domestic revenues were relatively flat in fiscal 1994. The Company's U.S.-based revenues accounted for approximately $68 million, including approximately $2.0 million in revenue derived from Avalanche Development Company, acquired in June 1993, compared with approximately $69 million in fiscal 1993, and $60 million in fiscal 1992. These results can be primarily attributed to two factors:

- Overall, in fiscal 1994, including Avalanche-based revenue, domestic software product revenue declined by approximately 7%, or $2.5 million, from fiscal 1993, and 1%, or $0.2 million, from fiscal 1992. As will be explained below, this is attributable to declining revenues from the Company's creation tool, Interleaf 5.
- In fiscal 1994, the Company's domestic operations experienced software revenue declines of approximately $5 million and $4 million, respectively, in large multi-year procurements, from fiscal 1993 and 1992. This decline underscores the impact of the Company's shift in its domestic customer base from large aerospace/defense concerns who acquire software in large multi-year procurements to project oriented procurements, that have longer sales and deployment cycles but offer strong growth opportunities.

International: Internationally, including Canada, the Company recorded revenue of approximately $43.1 million, or approximately 39% of the Company's worldwide revenue, compared with revenue of approximately $48 million in fiscal 1993 and $40 million in fiscal 1992.

The Company's fiscal 1994 international performance was negatively affected by its German operations, its largest foreign subsidiary, and its Canadian operations; both countries are undergoing difficult economic times. Germany's revenues declined by approximately $4 million over fiscal 1993, and returned to its fiscal 1992 level, while Canadian revenues declined by approximately $2 million from its fiscal 1993 level. As a result, in September 1993 the Company recorded a $3 million restructuring charge to consolidate its international operations and reduce headcount by approximately 45 people. Primarily because of the reduction in employment, the Company expects to realize annual savings of approximately $4 million. While this restructuring will improve profitability, revenue growth from these countries is not expected to improve until their economies improve. In the rest of Europe, revenue growth was not strong, but given the still relatively weak European economy, their operating performances were in line with the Company's projections. Revenue in Western Europe for fiscal 1994 was favorably impacted by approximately $3 million from a series of large multi-year procurements; there were no similar-sized procurements in Europe in fiscal 1993 and 1992. While these procurements reflect growing acceptance of the Company's products in the European marketplace, future revenue may be adversely affected unless new revenue opportunities are obtained.

The Company's Asia/Pacific operations, primarily Japan and Australia, experienced moderate growth, as revenues increased by 35% from fiscal 1993 to approximately $5.4 million. In Japan, unlike its other operations, the Company distributes its products through a network of large credit-worthy resellers and integrators who typically make large purchases ranging from $250 thousand to $1 million. As a result, the Company's Japanese revenues on a quarterly basis are more volatile based on its limited revenue base.

REVENUE GROWTH BY CATEGORY

Software Products: The composition of Interleaf's revenue continues to undergo significant changes. As mentioned above, the Company has three integrated software products, Interleaf 5 for document creation, WorldView for document viewing and distribution, and RDM for document management, that form the foundation of the Company's document management system. In fiscal 1994, the Company's authoring product, Interleaf 5, accounted for approximately $41 million compared with approximately $56 million in fiscal 1993, and $55 million in fiscal 1992. This revenue shortfall is primarily attributable to the rapid decline of purchases of the Company's authoring software by the aerospace/defense sector, historically the Company's largest customer base. This significant authoring revenue decline was only partially offset by the strong revenue growth in the Company's WorldView and RDM products that totalled approximately $20 million in fiscal 1994, compared with approximately $11 million in fiscal 1993 and $5 million in fiscal 1992. While the Company was encouraged with the near doubling of combined RDM and WorldView revenue, it recognizes that its authoring revenue must stabilize. As the Company's document management strategy develops, the Company believes that incremental revenue will be generated because of the rich functionality that Interleaf 5 provides in this environment. The customers' recognition of these attributes should distinguish the Company's authoring product from low-cost, low-end authoring products. Secondly, the Company expects to complete its port to Microsoft Corporation's Windows NT operating system environment, which the Company believes will expand its markets and attract new users.

Maintenance: The Company's maintenance business, which consists of providing telephone hot-line support, and bug fixes and upgrades to the Company's software products, remained stable as revenues totalled approximately $31 million for fiscal 1994 compared with approximately $31 million in fiscal 1993 and approximately $27 million in fiscal 1992. The Company was satisfied that maintenance revenues remained stable in light of the general downward pricing pressure on maintenance in the software industry and the decline in Interleaf 5 revenue in fiscal 1994. The bulk of the Company's maintenance revenue was derived from its document creation tool, Interleaf 5. In fiscal 1995, the Company will pursue maintenance contracts on its RDM products.

Services: The Company's services revenues, which include consulting and training, totalling approximately $19.6 million in fiscal 1994, were relatively flat compared with fiscal 1993, despite increased expenses of approximately $3 million. Service revenue for fiscal 1992 was $14.2 million. The increased expense was attributable to establishing the services' infrastructure (people and methodology tools) to adequately support anticipated growth. The Company's failure to significantly grow its service-based revenue adversely impacted the Company's strategy of providing integrated document management solutions at premium prices because of the high value it provides to customers. The Company is actively recruiting senior level project managers to improve its services' business. The success of the services' business will be critical to the overall success of the Company in fiscal 1995 and beyond.

COSTS AND EXPENSES

Selling, General and Administrative Expenses (SG&A): SG&A expenses in fiscal 1994 increased (exclusive of the restructuring charge of $3 million recorded in September 1993) by approximately $3 million over fiscal 1993, and approximately $8.5 million over fiscal 1992. The $3 million increase, however, was attributable to the expansion of the Company's Japanese subsidiary, which added approximately $2 million in expenses, and the addition of $1.1 million in expenses from the Company's Avalanche subsidiary, acquired in June 1993. The Company, nevertheless, recognizes that its selling costs are high relative to its revenue and that it must improve sales productivity. In fiscal 1995, the Company will continue to expand its telesales operation, which accounted for approximately $13 million in revenues in fiscal 1994, more than doubling its 1993 level. This operation primarily functions as a low cost fulfillment mechanism for processing the Company's orders from its existing customer base and therefore improves the productivity of the Company's direct sales channel.

Research and Development (R&D): The Company continues to maintain a high level of investment in R&D as expenditures accounted for approximately $21.2 million, or approximately 19% of total revenues in fiscal 1994, compared with approximately $20 million or 17% of revenues in fiscal 1993, and approximately $18 million, or 18% of revenues in fiscal 1992. This high level of investment is required given the Company's support of all major leading workstations, standard graphical user interface ("Motif"), which the Company completed in fiscal 1994, and the Windows NT operating system, to which it is currently porting. In addition, the Company supports these platforms in 14 foreign languages, which requires significant expenditures on foreign language translations. Moreover, the RDM and WorldView products must also support these platforms and operating systems, and be compatible with the Company's authoring product.

OPERATING AND NET INCOME/LOSS

The Company recorded an operating loss of approximately $9.2 million in fiscal 1994, which includes a restructuring charge of approximately $3 million recorded in September 1993 to consolidate operations and reduce headcount primarily in Canada and Germany, and a $4 million non-tax-deductible charge arising out of the acquisition of Avalanche Development Company. Without the $4 million Avalanche charge, the operating loss would have been approximately $5.2 million. These operating results are primarily attributable to software revenue shortfalls in the U.S., Canada and Germany, and from the Company's services business. Software revenues declined by approximately 9% from fiscal 1993, or by approximately $6 million, and because of the Company's relatively high fixed cost structure, its impact on profitability was significant.

In fiscal 1994, the Company adopted SFAS No. 109 "Accounting for Income Taxes" resulting in income in the form of a cumulative effect of a change in accounting principle of $1.9 million to the Company. This amount represents the Company's estimate of research and development credit carry-forwards that it considers probable of realization based upon existing levels of federal taxable income over the next several years, which is within the expiration of the carryforward period. As a result, for fiscal 1994 the Company had a net loss of approximately $8.45 million compared with net income of $9.3 million in fiscal 1993 and $6.0 million in fiscal 1992.

Liquidity and Capital Resources

The Company's financial position remained strong as cash and marketable securities were approximately $23.4 million at March 31, 1994, down from approximately $30.5 million at March 31, 1993. The Company's cash position at March 31, 1992 was approximately $18.2 million. The Company expended approximately $5.5 million in cash in its acquisition of Avalanche Development Company in June 1993, which accounts for a substantial portion of the Company's cash reduction. Avalanche is a leading developer of structured authoring technology, which the Company believes will be important to its future success. In addition, since the Company's $3 million restructuring in September 1993 primarily reduced headcount by 45 people, significant cash was expended for severance payments. Specifically, $1.9 million was expended in the Company's third and fourth quarters for severance; the balance, approximately $1.1 million, will be substantially expended in fiscal 1995 for facilities' consolidation. This restructuring is expected to generate annual savings of approximately $4 million. The Company invests its available cash in short-term money market funds and high-grade bonds having a maturity of less than 90 days.

The Company's relatively strong cash position, in spite of its operating losses in fiscal 1994, reflects the moderate capital needs of being a software and services provider. The Company invested approximately $5.2 million in fiscal 1994, primarily to upgrade its corporate information network, while depreciation expenses totalled approximately $4.5 million. The Company expects to spend approximately $6 million on property and equipment in fiscal 1995, which will be financed through leases or internal funds. The Company believes that its strong cash position provides adequate liquidity to meet the Company's investment and capital needs in the foreseeable future.

The Company does recognize that it must improve its receivables' collections, which increased by approximately $3 million over fiscal 1993, even though total revenue declined by $6 million in fiscal 1994. The Company's days of sales outstanding (DSO) increased to 109 days in fiscal 1994, up from 92 days in fiscal 1993. This increase is primarily attributable to several large multi-year agreements with global companies, who have extended payment terms. The Company will increase its focus in fiscal 1995 on controlling its payment terms.

The Company has a joint venture with PruTech Research and Development III (PruTech), whereby, on behalf of the venture, it markets WorldView on personal computers and mainframes, and its CALS product used in U.S. Defense Department procurements. Because of the relatively low level of profitability of the venture, and the need to fund enhancements to the products to remain competitive, the venture made no cash distributions during fiscal 1993 and fiscal 1994. PruTech, however, alleges that it is entitled to mandatory cash distributions of 30% of all of the venture's revenues; the Company believes that this position is without merit. PruTech has the right to purchase the Company's interest in the venture under various terms and conditions. In the event PruTech exercises its right to purchase, it could preclude the Company from marketing these and competing products in certain areas of the United States. In March 1994, PruTech commenced an arbitration proceeding against the Company alleging that the Company should be paying a cash distribution and that it has used venture owned technology in other products. The Company has denied these allegations, and believes that in any event the outcome of the arbitration proceeding will not have a material adverse impact on the Company.

With the Company's high fixed cost structure, any fluctuation in revenue will have a significant impact on its profitability. Since the Company's sales cycles have become longer and more complex when involving large document management systems procurements, and given that a large part of the Company's revenues occur in the last month of the quarter in any event, the Company's actual results in any one quarter can be volatile, and are often unpredictable until the very end of the quarter.

(in thousands except for per share amounts)

Year ended March 31	1994	1993	1992
REVENUES			
Products	$ 60,924	$ 66,752	$ 59,372
Maintenance	30,725	30,923	26,758
Services	19,580	19,666	14,169
Total revenues	111,229	117,341	100,299
COSTS OF REVENUES			
Products	5,770	4,845	4,417
Maintenance	6,918	6,391	6,546
Services	20,577	17,665	13,469
Gross margin	77,964	88,440	75,867
OPERATING EXPENSES			
Selling, general and administrative	58,958	55,831	50,398
Research and development	17,332	16,302	14,720
Amortization of capitalized software development costs	3,870	3,671	3,382
Charge for purchased research and development	3,985	–	–
Restructuring expense	3,000	–	–
Total operating expenses	87,145	75,804	68,500
Income (loss) from operations	(9,181)	12,636	7,367
Interest expense	(442)	(724)	(976)
Interest income	675	721	962
Other expense, net	(982)	(1,004)	(840)
Income (loss) before taxes and cumulative effect of change in accounting principle	(9,930)	11,629	6,513
Provision for income taxes	418	2,326	529
Income (loss) before cumulative effect of change in accounting principle	(10,348)	9,303	5,984
Cumulative effect of change in accounting principle-accounting for income taxes	1,900	–	–
Net income (loss)	$ (8,448)	$ 9,303	$ 5,984
PRIMARY AND FULLY DILUTED EARNINGS (LOSS) PER SHARE			
Earnings (loss) before cumulative effect of change in accounting principle	$ (.77)	$ .55	$ .38
Cumulative effect of change in accounting principle	.14	–	–
Net earnings (loss)	(.63)	.55	.38
Shares used in computing primary earnings (loss) per share	13,384	16,836	15,704
Shares used in computing fully diluted earnings (loss) per share	13,384	16,925	15,747

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

(in thousands except for share amounts) March 31	1994	1993
Assets		
CURRENT ASSETS		
Cash and cash equivalents	$ 23,364	$ 26,402
Marketable securities	–	4,070
Accounts receivable, net of allowance of $1,169 and $725 for doubtful accounts, respectively	34,932	32,051
Prepaid expenses and other current assets	2,506	2,284
TOTAL CURRENT ASSETS	60,802	64,807
Property and equipment, net	10,156	9,494
Excess of purchase price over net assets of businesses acquired	15,435	16,402
Deferred taxes	1,258	–
Other assets	9,233	8,816
	$96,884	$99,519
Liabilities and Shareholders' Equity		
CURRENT LIABILITIES		
Accounts payable	$ 3,200	$ 3,143
Accrued expenses	11,779	8,414
Accrued compensation and related items	6,418	6,491
Unearned service revenues	14,626	13,589
Current portion of capital lease obligations	1,763	1,458
Other liabilities	901	888
TOTAL CURRENT LIABILITIES	38,687	33,983
Capital lease obligations, less current portion	1,060	1,594
Other liabilities, less current portion	505	263
Deferred taxes	–	553
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 1,785,715 and 1,928,572 shares, respectively (liquidation value $7 per share)	179	193
Common stock, par value $.01 per share, authorized 30,000,000 shares in 1994 and 20,000,000 shares in 1993, issued and outstanding 13,630,657 and 13,064,139 shares, respectively	136	131
Additional paid-in capital	65,551	63,507
Retained-earnings deficit	(8,907)	(459)
Equity adjustment for foreign currency translation	(327)	(246)
	56,632	63,126
	$96,884	$99,519

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(in thousands)	Preferred Stock Senior Series B	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Equity Adjustment	Total Shareholders' Equity
Balances at March 31, 1991	$214	$121	$60,174	$(15,746)	$ (32)	$44,731
Common stock issued in connection with incentive stock options exercised by employees	–	2	1,324	–	–	1,326
Common stock issued in connection with employees stock purchase plan	–	1	184	–	–	185
Equity adjustment for foreign currency translation	–	–	–	–	(118)	(118)
Net income	–	–	–	5,984	–	5,984
Balances at March 31, 1992	214	124	61,682	(9,762)	(150)	52,108
Conversion of Senior Series B Convertible Preferred stock into common stock	(21)	3	18	–	–	–
Common stock issued in connection with incentive stock options exercised by employees	–	2	923	–	–	925
Common stock issued in connection with employee stock purchase plan	–	2	884	–	–	886
Equity adjustment for foreign currency translation	–	–	–	–	(96)	(96)
Net income	–	–	–	9,303	–	9,303
Balances at March 31, 1993	193	131	63,507	(459)	(246)	63,126
Conversion of Senior Series B Convertible Preferred stock into common stock	(14)	2	12	–	–	–
Common stock issued in connection with incentive stock options exercised by employees	–	2	739	–	–	741
Common stock issued in connection with employee stock purchase plan	–	1	1,293	–	–	1,294
Equity adjustment for foreign currency translation	–	–	–	–	(81)	(81)
Net loss	–	–	–	(8,448)	–	(8,448)
Balances at March 31, 1994	$179	$136	$65,551	$ (8,907)	$(327)	$56,632

See Notes to Consolidated Financial Statements.

(In thousands) **Year ended March 31**	**1994**	**1993**	**1992**
OPERATING ACTIVITIES			
Net income (loss)	$ (8,448)	$ 9,303	$ 5,984
Change in accounting principle-accounting for income taxes	(1,900)	–	–
Charge for purchased research and development	3,985	–	–
Restructuring expense	3,000	–	–
Depreciation and amortization expense	6,674	8,043	7,879
Amortization of capitalized software development costs	3,870	3,671	3,382
Loss from disposal of property and equipment	153	137	202
Provision for deferred income taxes	89	402	–
Changes in current accounts excluding the effects of acquisitions:			
Increase unearned revenue	1,052	971	3,153
Increase accounts receivable, net	(2,641)	(2,380)	(4,849)
(Increase) decrease other current assets	(187)	(228)	1,063
Increase accounts payable and other current liabilities	3,314	1,056	3,945
Decrease in accrued restructuring costs	(2,092)	(522)	(878)
Other, net	(41)	62	(330)
Net cash provided by operating activities	6,828	20,515	19,551
INVESTING ACTIVITIES			
(Increase) decrease marketable securities	4,070	(4,070)	–
Additions to property and equipment	(5,232)	(4,569)	(5,134)
Capitalized software development costs	(4,064)	(4,034)	(3,691)
Payments for acquisitions of businesses, net of cash acquired	(5,342)	–	(7,541)
Increase in other non-current assets	(489)	(847)	(438)
Net cash used in investing activities	(11,057)	(13,520)	(16,804)
FINANCING ACTIVITIES			
Net proceeds from issuance of common stock	2,035	1,811	1,511
Property and equipment financing	1,375	1,794	2,376
Repayment of long-term debt and capital leases	(2,254)	(2,374)	(2,040)
Net cash provided by financing activities	1,156	1,231	1,847
Effect of exchange-rate changes on cash	35	(51)	12
Net increase (decrease) in cash and cash equivalents	(3,038)	8,175	4,606
Cash and cash equivalents at beginning of year	26,402	18,227	13,621
Cash and cash equivalents at end of year	$23,364	$26,402	$18,227

See Notes to Consolidated Financial Statements.

Note A Significant Accounting Policies

Business	The Company, a Massachusetts corporation, was incorporated on May 27, 1981 and develops and markets software, services and customized solutions used in the creation, management, and distribution of complex documents.
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 and unrealized exchange gains or losses from transaction adjustments are reflected in operations and are not material.
Revenue Recognition	The Company recognizes revenue from the license of software upon delivery of the software product to the customer's place of business or to another site specified by the customer if there are no, or insignificant company obligations. If a software license includes insignificant obligations, the software revenue is recognized immediately and the services costs to be performed are either accrued or a pro-rata portion of the revenue is deferred and recognized ratably as the obligations are met or upon completion. If a software license includes significant obligations revenue is recognized, depending upon the nature of the obligations, upon fulfillment of the obligations or ratably, as the earnings process related to segments of the agreement are completed. When payment terms for the license of software exceed one year, the Company recognizes as revenue only payments for which collection is more than reasonably assured, which represents payments due within one year of the balance sheet date. Contractual maintenance revenues are recognized ratably over the contract period, generally one year or quarterly, and non-contractual maintenance revenues are recognized as the services are performed. Services revenues (consulting and training) are recognized as the Company successfully performs the obligations specified under agreements with its customers on either a time and material basis or pro rata based on percent of project or contract completion determined by costs incurred to date to total costs upon completion. The Company generates revenue from sales of its products and services to a large number of customers across different industries and diverse geographic areas. Credit is extended based on evaluation of the customer's financial condition and collateral is not required. Credit losses have been incidental to the Company's operations.
Cash Equivalents and Marketable Securities	Cash equivalents represent investments with maturities at date of purchase of less than three months. Marketable securities represent investments with maturities of three to six months. Marketable securities are accounted for at cost which approximates market value. Marketable securities consist of investment grade commercial paper and the amount of credit exposure related to any one commercial issue is limited. Adoption of Statement of Financial Accounting Standards No. 115 "Accounting for Certain Investments in Debt and Equity Securities" as required on April 1, 1994, will not have a material effect on the Company's consolidated financial statements.
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 the purchase price over net assets of acquired businesses is amortized over 15 to 25-year periods to other expense.
Income Taxes	Effective April 1, 1993, the Company adopted Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes" which was issued in February 1992. This statement requires the use of the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. As permitted under the new rules, prior years' financial statements have not been restated. The cumulative effect of the change in the method of accounting for income taxes has been reported in the 1994 consolidated statement of operations. Pursuant to the liability method under the Statement of Financial Accounting Standards No. 96, which was applied in 1992 and 1993, deferred income taxes are recognized for temporary differences between financial and taxable income, attributable principally to depreciation, restructuring, and research and development costs. 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 share equivalents outstanding during the year. Common share equivalents are attributable to stock options, common stock warrants and convertible preferred stock.
Basis of Presentation	Certain 1992 and 1993 amounts have been reclassified to conform to the 1994 method of presentation.

Note B 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 beginning when the product is available for general release to customers. The amortization is the greater of the amount computed using the ratio of current gross revenues to total current and anticipated gross revenues or straight line over the estimated remaining useful life of the product not to exceed three years. The unamortized portion of capitalized software development costs included in other assets amounted to $6,187,000 and $5,995,000 at March 31, 1994 and 1993, respectively.

Note C Property and Equipment

Property and equipment at March 31 consists of the following:

(in thousands)	1994	1993
Office and demonstration equipment	$ 25,292	$ 22,805
Development equipment	11,147	9,543
Furniture	4,455	4,245
Leasehold improvements	701	593
	41,595	37,186
Less allowances for depreciation and amortization	31,439	27,692
	$ 10,156	$ 9,494

Note D Accrued Expenses

Accrued expenses at March 31 consists of the following:

(in thousands)	1994	1993
Royalties	$ 2,311	$ 1,229
Rent	2,332	2,154
Other	7,136	5,031
	$11,779	$ 8,414

Note E Leases and Other Obligations

The Company leases its facilities, including sales offices, and certain equipment under various operating leases, which expire through the year 2000. The Company also leases certain assets under capitalized leases. Equipment under capital leases has been included with company-owned assets under the caption property and equipment, net, in the balance sheet. At March 31, 1994, the cost of these assets was $5,937,000 of which $2,390,000 has been amortized. Future minimum rental payments at March 31, 1994 under agreements classified as operating and capital leases with non-cancellable terms in excess of one year are as follows:

(in thousands) **Fiscal years ending March 31**	**Operating Leases**	**Capital Leases**
1995	$ 8,388	$ 1,895
1996	7,378	907
1997	6,138	201
1998	5,529	–
1999	4,274	–
Thereafter	6,960	–
Total minimum lease payments	$38,667	3,003
Less amount representing interest (interest rates range from 6 – 8 1/3%)		180
Present value of net minimum lease payments		$ 2,823

The operating lease minimum payments are based on the Company's existing leases including certain renewal options.

Rent expense amounted to $9,356,000, $9,725,000, and $8,728,000 for the years ended March 31, 1994, 1993 and 1992, respectively.

Note F 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 shareholders 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 not 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 non-voting, 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 have a liquidation preference over all other shareholders of the Company and are entitled to receive $7.00 per share. Thereafter, all other shareholders are 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 have been entitled to receive upon conversion. Finally, the Series B holders and common shareholders 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 are 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 are entitled to elect one director and the Company needs the approval of the majority of the Series B holders on certain significant events.

The Series B holders could originally convert their preferred stock into common stock on a one-for-one basis (Conversion Ratio). This Conversion Ratio was subject to three adjustments based on the average closing price of the Company's common stock in the National Market System as reported by NASDAQ for periods ranging from ten to twenty days after the release of earnings for the fiscal years ended 1990, 1992 and 1993. An adjustment with respect to fiscal 1990 was made, and the Conversion Ratio increased to 1.09375, which resulted in an additional 200,893 shares of common stock being issuable upon conversion. A second adjustment with respect to fiscal 1992 was made, and the Conversion Ratio increased to 1.34375, which resulted in an additional 535,714 shares of common stock being issuable upon conversion. There was no final adjustment to the Conversion Ratio based on the fiscal 1993 earnings release. Therefore, the total effect of the adjustments was an additional 736,607 shares of common stock being issuable at time of conversion. In fiscal 1993, 214,285 shares of Series B Convertible Preferred Stock were converted at the shareholders' request into 287,945 shares of the Company's common stock. In fiscal 1994, 142,857 shares of Series B Convertible Preferred Stock were converted at the shareholders' request into 191,964 shares of the Company's common stock.

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 shares of Senior Series B Convertible Preferred Stock are 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, at which point the options expire. Under these warrants, ABS can purchase up to 335,892 shares at a per share exercise price of $5.21.

As of March 31, 1994, 6,414,933 shares of common stock were reserved for issuance.

The Board of Directors in May, 1993 voted to amend the Company's Restated Articles of Organization to increase the Company's authorized shares of its Common Stock, .01 par value, by an additional 10,000,000 shares, from 20,000,000 to 30,000,000, which amendment was subsequently approved by the shareholders at the Special Meeting in Lieu of an Annual Meeting held on August 5, 1993.

Note G Stock Option and Stock Purchase Plans

Under the Company's 1983 Stock Option Plan ("1983 Stock Option Plan") options to purchase shares of common stock were granted to key officers and employees. The options expire after 10 years from date of grant. Options are subject to vesting provisions generally between three to five years from date of grant. Options are non-transferable other than in the event of death. Under the 1983 Stock Option Plan, at March 31, 1994, options covering 1,298,148 shares were outstanding, of which 916,209 were exercisable. The 1983 Stock Option Plan expired on June 24, 1993. In May, 1993 the Company's Compensation Committee of the Board of Directors approved, with subsequent ratification by the shareholders, the Company's 1993 Stock Option Plan ("1993 Stock Option Plan"), which contains substantially similar terms and conditions of its 1983 Stock Option Plan. Under the Company's 1993 Stock Option Plan, at March 31, 1994, options covering 255,000 shares were outstanding, and 495,000 shares were available for future grants.

A summary of activity combined for both Plans is presented below:

	Number of Shares	Price Range of Shares
Outstanding at March 31, 1991	1,802,436	$ .57 – $19.38
Granted	188,700	5.25 – 12.50
Exercised	(303,116)	1.13 – 10.00
Cancelled	(265,846)	3.13 – 19.38
Outstanding at March 31, 1992	1,422,174	.57 – 19.38
Granted	425,750	8.38 – 11.38
Exercised	(172,701)	.57 – 8.38
Cancelled	(141,777)	3.13 – 16.50
Outstanding at March 31, 1993	1,533,446	1.13 – 19.38
Granted	485,350	6.75 – 9.50
Exercised	(192,805)	1.13 – 7.50
Cancelled	(272,843)	3.13 – 15.87
Outstanding at March 31, 1994	1,553,148	$1.13 – $19.38

Under the Company's 1989 Director Stock Option Plan, options to purchase up to 150,000 shares of common stock at a price equal to fair market value at the date of grant may be issued to non-employee directors. In March 1989, each then 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. In future years, each newly elected non-employee director may receive options to purchase up to 20,000 shares of common stock, which vest over a three-year period, upon election as director. On the fourth anniversary date of the initial grant of options, and on each annual anniversary date thereafter, each non-employee director who continues to serve as a director of the Company will be granted an option to purchase 3,000 shares of common stock at the then current fair market value, which is exercisable on the date of grant. At March 31, 1994, options under the 1989 Plan for the purchase of 36,000 shares were outstanding, all of which are exercisable. In September 1993, the Board of Directors approved, subject to shareholder approval at the August 4, 1994 Annual Meeting, the 1993 Director Stock Option Plan ("1993 Director Stock Option Plan"). The 1993 Director Stock Option Plan would replace the 1989 Director Stock Option Plan, effective as of September 8, 1993. Under the 1993 Director Stock Option Plan, options to purchase up to 150,000 shares of common stock may be issued to non-employee directors. Each non-employee director would automatically receive a grant of 5,000 shares on each April 1 at the then fair market value on date of grant, which grant would fully vest one year later. During fiscal 1994, each director received a grant of 5,000 shares. At March 31, 1994, options under the 1993 Plan for the purchase of 25,000 shares were outstanding, none of which were exercisable.

Under the Company's Employee Stock Purchase Plan, eligible officers and 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 (one year after commencement date), whichever is lower. The plan, as amended, allows for the purchase of up to 1,750,000 shares of common stock.

As of March 31, 1994, 2,048,148 shares of common stock under the 1983 and 1993 Stock Option Plans, 814,052 shares of common stock under the employee stock purchase plan, and 186,000 shares under the 1989 and 1993 Director Stock Option Plans were reserved for issuance.

Note H Income Taxes

The provision for income taxes is composed of the following:

(in thousands)	1994	1993	1992
Current:			
Federal	$ 171	$ 1,149	$ 170
State	50	230	288
Foreign	108	545	71
Total current	329	1,924	529
Deferred:			
Federal	35	298	–
State	54	104	–
Total deferred	89	402	–
	$ 418	$ 2,326	$ 529

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

(in thousands)	1994	1993	1992
Domestic	$(4,184)	$10,416	$6,680
Foreign	(5,746)	1,213	(167)
	$(9,930)	$11,629	$6,513

Significant components of the Company's deferred tax assets and (liabilities) as of March 31, 1994 are as follows:

(in thousands)	1994
Deferred tax assets:	
Net operating loss carryforwards—foreign	$ 5,691
Tax credit carryforwards	5,724
Accrued rent	897
Allowance for uncollectible accounts receivable, vacation and other accruals	583
Other	137
Total deferred tax assets	13,032
Deferred tax asset valuation allowance	(8,922)
	4,110
Deferred tax liabilities:	
Research and development costs, net of amortization	(2,382)
Depreciation	(451)
Other	(19)
Total deferred tax liabilities	(2,852)
Net deferred tax asset	$ 1,258

Realization of total deferred assets is contingent upon future taxable income. The valuation allowance has been established based upon the Company's estimate of benefits related to these assets which as of March 31, 1994 are not considered probable of realization.

The deferred tax asset valuation allowance increased by $2,282,000 from the adoption of SFAS No. 109 on April 1, 1993 to March 31, 1994.

The components of the Company's deferred income tax provision for the years ended March 31, 1993 and March 31, 1992 are as follows:

(in thousands)	1993	1992
Research and development costs, net of amortization	$ 111	$ 104
Allowance for uncollectible accounts receivable, vacation and other accruals	26	4
Inventory adjustments	(18)	40
Depreciation	8	(507)
Restructuring accrual less amounts for which no tax benefit was realized	161	299
Accrued rent	(169)	(13)
Deferred software revenue	291	–
Other, net	(8)	73
	$ 402	$ 0

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:

(in thousands)	1994	1993	1992
Computed at federal statutory rate	$(3,376)	$ 3,954	$ 2,214
State income taxes, net of federal tax benefit	33	152	190
Nondeductible amortization	385	341	337
Purchased research and development	1,355	–	–
Other nondeductible expenses	61	40	221
Loss for which no tax benefit was realized	2,131	207	215
U.S. and foreign tax rate difference	–	187	–
Benefit of net operating loss carryforward	(153)	(807)	(2,642)
Benefit of tax credits	–	(1,776)	–
Other, net	(18)	28	(6)
	$ 418	$ 2,326	$ 529

At March 31, 1994, the Company and its subsidiaries had net operating loss carryforwards of approximately $15 million that are available to offset future taxable income. The loss carryforwards are attributable to non-U.S. operations in several tax jurisdictions and expire in 1996 and thereafter.

In addition, the Company has research and development and other tax credit carryforwards of approximately $5.8 million available to reduce future federal and state income tax liabilities through the year 2008. During 1994, 1993 and 1992, the Company made $48,650, $1,530,000, $358,000 in income tax payments, respectively.

Note I Research and Development Agreements

In January 1991, the Company exercised an option relating to a research and development arrangement entered into in 1987 to purchase the remaining rights in a joint venture with ML Technology Ventures L.P. (MLTV). Under the terms of the agreement, the Company exercised its option to purchase all of MLTV's rights in the joint venture under the following modified terms: (1) payment of $2,750,000, (2) issuance of a warrant to purchase 150,000 shares of the Company's common stock through December 1995 at an exercise price of $3.50, (3) a reduction of the per share exercise price to $3.50 for the original warrant covering 125,000 shares and extension of its maturity to December 1995.

In September, 1988, the Company entered into a joint venture (the Venture) with PruTech Research and Development Partnership III (PruTech) under which it markets products developed by the Venture. The Company receives 65% of revenues from the sale of such products for expenses. Through October 1, 1991, all of the profits of the Venture, up to 30% of recorded revenues, were allocated to Interleaf, with the remainder being allocated to PruTech. When cash distributions were made by the Venture, 86% were distributed to Interleaf, with the balance to Pru-Tech. Commencing October 1, 1991, PruTech has been allocated all of the profits of the Venture up to 30% of recorded revenues, with the balance being allocated to the Company; 86% of the distributable cash, of the Venture, if any, is to be distributed to PruTech, with the remainder to Interleaf. Since June 1991, the Venture has been using all available cash for research and development and no cash has been distributed. PruTech, however, claims that it is entitled to mandatory cash distributions of 30% of all of the Venture's revenues which PruTech also claims do not include all of the revenue attributable to the Venture. The Company believes that this position is without merit and, in any event, believes that the outcome will not have a material adverse effect on the operation of the Company. In March 1994, PruTech submitted this dispute to mandatory arbitration. 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 such event, the Company will lose the right to market the products owned by the venture including WorldView on IBM-compatible personal computers. The Company recorded net revenues from the sale of joint venture products of approximately $2.1 million, $1.6 million, and $1.3 million for fiscal years 1994, 1993, and 1992, respectively.

In connection with the arrangement, PruTech obtained a warrant at a cost of $180,000 to purchase 290,039 shares of the Company's common stock, subject to certain adjustments, through October 1995 at $6.40 per share. This amount is included in additional paid in capital. An adjustment to the warrant was made in May 1992 increasing the number of shares to 356,286 at a reduced price of $5.21 per share.

Note J Acquisition

On June 16, 1993, the Company purchased all of the outstanding equity securities of Avalanche Development Company ("Avalanche") for cash of $5,500,000. Avalanche is a leading provider of document analysis and conversion technology and services, with particular emphasis on Standard Generalized Markup Language ("SGML"), the leading international standard for electronic interchange of documents and data.

The acquisition was accounted for using the purchase method of accounting, whereby purchase price allocations were made to assets acquired and liabilities assumed based on their respective fair values as of the date of the acquisition. In connection with this acquisition, a significant portion of the purchase price was allocated to purchased research and development, resulting in a charge to the Company's operations of $3,985,000. The charge was not deductible for tax purposes. Intangibles of $800,000, included in other non-current assets, were recorded as part of the acquisition and are being amortized on a straight-line basis over four years.

Note K Restructuring

After experiencing less-than-expected operating results in the first half of fiscal 1994 due to the continuing recession in Europe and due to an expense structure not consistent with the volume and direction of the business, the Company initiated a plan to restructure certain of its worldwide operations. This plan should result in annual savings of approximately $4 million. The Plan provided for reduction of headcount, consolidation and elimination of sales offices, primarily in Europe and Canada, and deployment of more resources towards the Company's services business in anticipation of further growth.

As a result, during the second quarter of fiscal 1994, the Company recorded a $3 million pre-tax charge to operations for severance costs, outplacement, and facility closing costs. At March 31, 1994, $1,915,000 of the restructuring charge was paid and $1,085,000 was accrued. Of the amount accrued, $791,000 was included in the current portion and $294,000 was included in the long term portion of other liablities.

Note L Industry Segment and Geographic Information

The Company, which operates in a single industry segment, designs, develops and markets software used in the creation, management and distribution of complex documents, integrated with customized services.

Information regarding geographic areas at March 31, 1994 and 1993, and for the years then ended is as follows:

(in thousands) **March 31, 1994 and for the year then ended**	North America	Europe	Asia/Pacific	Eliminations	Total
Sales to unaffiliated customers	$ 72,445	$33,576	$5,208	$ –	$111,229
Intercompany transfers	12,008	–	–	(12,008)	–
Net revenues	84,453	33,576	5,208	(12,008)	111,229
Income (loss) from operations	(4,903)	(2,472)	(1,806)	–	(9,181)
Identifiable assets	109,633	16,894	3,079	(32,722)	96,884
March 31, 1993 and for the year then ended	**North America**	**Europe**	**Asia/Pacific**	**Eliminations**	**Total**
Sales to unaffiliated customers	$ 78,730	$36,818	$1,793	$ –	$117,341
Intercompany transfers	10,889	–	–	(10,889)	–
Net revenues	89,619	36,818	1,793	(10,889)	117,341
Income (loss) from operations	11,196	1,659	(219)	–	12,636
Identifiable assets	112,751	14,678	2,206	(30,116)	99,519

Intercompany transfers between geographic areas are accounted for at prices that approximate prices charged to unaffiliated customers.

Board of Directors
Interleaf, Inc.

We have audited the accompanying consolidated balance sheets of Interleaf, Inc. and subsidiaries as of March 31, 1994 and 1993, 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, 1994. 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, 1994 and 1993, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 1994, in conformity with generally accepted accounting principles.

As described in Note H, the Company changed its method of accounting for income taxes.

Ernst + Young

Boston, Massachusetts
April 26, 1994

SUPPLEMENTAL FINANCIAL INFORMATION

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1994 and 1993 and the market range for the Company's common stock for those periods:

(in thousands except for per share amounts) Quarter ended	June 30	September 30	December 31	March 31	Year
FISCAL 1994					
Revenues	$27,184	$26,679	$28,415	$28,951	$111,229
Gross Profit	19,212	18,237	19,974	20,541	77,964
Income (loss) before cumulative effect of change in accounting principle	(4,968)	(6,062)	40	642	(10,348)
Net income (loss)	(3,068)	(6,062)	40	642	(8,448)
Income (loss) per share before cumulative effect of change in accounting principle	(.38)	(.46)	–	.04	(.77)
Net income (loss) per share	(.23)	(.46)	–	.04	(.63)
Common stock prices					
High	9 7/8	8 7/8	8 1/4	8 3/4	9 7/8
Low	6 7/8	6	4 7/8	6 3/8	4 7/8
FISCAL 1993					
Revenues	$26,489	$28,436	$31,039	$31,377	$117,341
Gross Profit	19,862	21,334	23,428	23,816	88,440
Net income	1,446	1,864	2,956	3,037	9,303
Net income per share	.09	.11	.17	.18	.55
Common stock prices					
High	12 1/2	11	13 3/8	13 5/8	13 5/8
Low	7 7/8	7 3/4	8 7/8	8 5/8	7 3/4

The Company has never paid cash dividends. 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 4, 1994, there were 1,060 holders of record of the Company's common stock.

SELECTED FIVE-YEAR FINANCIAL DATA

(in thousands except for per share amounts) Year ended March 31	1994 a	1993	1992 b	1991	1990 c
FOR THE YEAR					
Total revenues	$111,229	$117,341	$100,299	$84,318	$88,843
Net income (loss)	(8,448)	9,303	5,984	(1,278)	(16,008)
Net income (loss) per share	(0.63)	0.55	0.38	(0.11)	(1.37)
AT YEAR END					
Total assets	96,884	99,519	87,573	71,711	68,502
Long-term obligations	1,565	1,857	2,559	3,048	3,809
Total shareholders' equity	56,632	63,126	52,108	44,731	45,195

a. Fiscal 1994 results include a nondeductible charge of $4.0 million for acquired research and development in connection with the acquisition of Avalanche Development Company in June 1993, a $3 million charge for restructuring of the Company's worldwide operations, and a $1.9 million benefit upon adoption of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," effective April 1, 1993.

b. Fiscal 1992 results include the impact of the acquisition of Interleaf GmbH in July 1991.

c. Fiscal 1990 results include the impact of the acquisition of Interleaf France S.A. and a $13.9 million charge for restructuring of the Company's infrastructure.

Executive Officers

Lawrence S. Bohn
Senior Vice President of Marketing and Business Development

Peter Cittadini
Senior Vice President of Worldwide Operations

Richard P. Delio
Senior Vice President of Finance and Administration and Chief Financial Officer

Paul English
Senior Vice President of Engineering

John K. Hyvnar
General Counsel and Clerk

Mark K. Ruport
President and Chief Executive Officer

Haviland Wright
Senior Vice President of Interleaf, Inc., and Chief Scientist

Board of Directors

Frederick B. Bamber
General Partner
Applied Technology Partners, L.P.

David A. Boucher
Chairman of the Board
Interleaf, Inc. and
General Partner
Applied Technology Partners, L.P.

André Harari
Directeur Général
Compagnie Financière du Scribe

Clinton P. Harris
Senior Vice President
Advent International Corporation

George D. Potter, Jr.
President
Quality Systems International

Mark K. Ruport
President and Chief Executive Officer
Interleaf, Inc.

Patrick J. Sansonetti
Senior Vice President
Advent International Corporation

Interleaf Fellows

Valerie Beaubien

Mats Borgestedt

Mark S. Dionne

Kimbo B. Mundy

Kirk L. Reistroffer

Robert Watkins

David Weinberger

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 4, 1994 at 8:30 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.
Prospect Place, 9 Hillside Avenue
Waltham, MA 02154

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) 290.0710

Independent Auditors

Ernst & Young
Boston, MA

Legal Counsel

Hale and Dorr
Boston, MA

Corporate Directory

Corporate Headquarters

Interleaf, Inc., Prospect Place
9 Hillside Avenue
Waltham, MA 02154 USA

SALES OFFICE

United States

Phoenix, Arizona; Irvine, El Segundo, Redwood Shores, California; Boulder, Colorado; Stanford, Connecticut; Tampa, Florida; Atlanta, Georgia; Oakbrook Terrace, Illinois; Greenbelt, Maryland; Waltham, Massachusetts; Southfield, Michigan; St. Louis, Missouri; Iselin, New Jersey; New York, New York; Raleigh, North Carolina; Nashville, Tennessee; Irving, Houston, Texas; Bellevue, Washington

Canada

Mississauga, Ottawa, Ontario

International

Sydney, South Yarra, Australia; Vienna, Austria; Brussels, Belgium; Paris, France; Düsseldorf, Eschborn, Frankfurt, Hamburg, Munich, Stuttgart, Germany; Milan, Italy; Tokyo, Japan; Madrid, Spain; Stockholm, Sweden; Lausanne, Zurich, Switzerland; Weybridge, Surrey, U.K.

Copy

Adeline Chan
Interleaf Corporate Design Group

Design

Pam Simonds
Interleaf Corporate Design Group

Photography

Pierre-Yves Goavec

Ian Tuck

Portrait of Mark Ruport, *Robert Schoen*
Page 10, *Philippe Stroppa*
Page 11, *Françis Bertrand*
Page 14, 15, *courtesy of Douglas Aircraft Company*