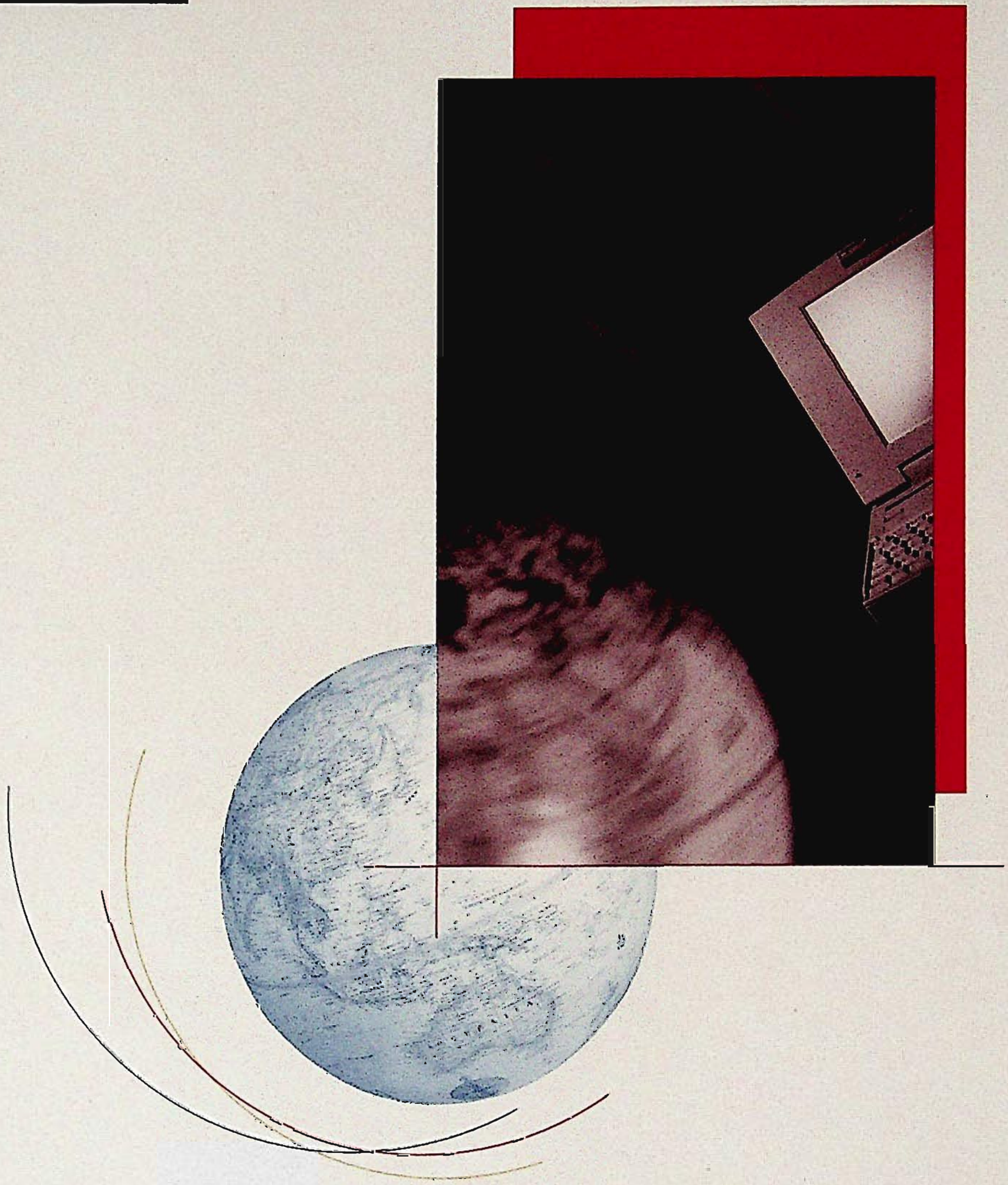
Interleaf



Interleaf, Inc. *Annual Report 1995*

Interleaf is the leading worldwide supplier of an integrated suite of software and systems that automate information-intensive business processes. Interleaf's technology spans the spectrum of information needs, from electronic document preparation, publishing and distribution to systems and custom solutions that support the management of business information in documents.

Founded in 1981, Interleaf began shipping products in 1984 and became a public company in 1986. Today, Interleaf has over a million users and offices in the United States, Canada, Japan, Australia, France, Belgium, Spain, Germany, the United Kingdom, Italy, Switzerland and Sweden. Interleaf products are sold in over 27 countries around the world. Interleaf software supports multiple languages, including English, French, German and Japanese. This unparalleled global reach uniquely positions Interleaf to benefit a worldwide customer base.

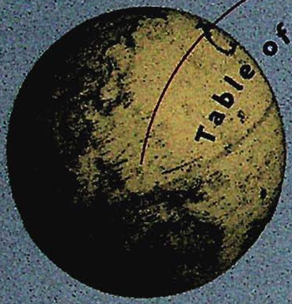
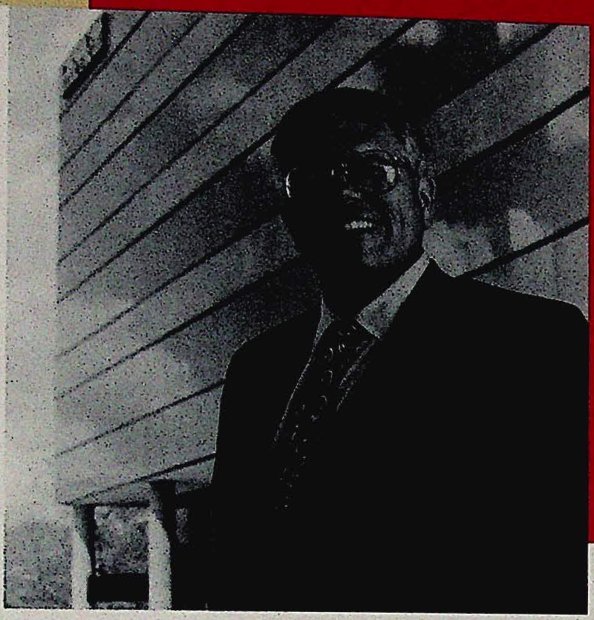


Table of Contents

To Our Shareholders



Fiscal 1995 was a difficult year for Interleaf. The large and unexpected loss during our first quarter caught the Company off guard and brought underlying operational problems to the surface. The rest of the year was spent addressing these issues. I joined Interleaf as President and CEO during the third quarter, charged with returning the Company to profitable growth and to its position as a recognized industry leader.

In reviewing fiscal 1995, I believe that the Company's problems were operational and executional in nature. This resulted in late product deliveries, customer and marketplace confusion, low employee morale and an excessive expense level. The Company took the following corrective actions: headcount was reduced by over 25 percent; total costs and expenses were reduced by an estimated $13 million to $15 million on an annualized basis; real estate requirements were reviewed and Interleaf adopted a "virtual office" concept wherever possible, allowing us to close 19 offices; a new management team was assembled to lead the firm; a solid line of credit was established to give the Company increased liquidity; and one or more layers of management were removed from each department, leading to a flatter organization with better communications. In addition, all research and development projects have been evaluated to confirm that they are in the best interests of the Company's long-term strategy. For example, the Company halted a large project in the fourth quarter, resulting in a significant charge to the operating results. Although forced restructuring has been a painful and arduous task for both Interleaf and our customers, we have achieved a new, leaner organization, a renewed enthusiasm for our products and industry, and a shared sense of purpose.

In spite of the difficulties of the past year, Interleaf brought a number of products and enhancements to market. The success of these products demonstrates that Interleaf is still in touch with the needs of its customer base. We were especially pleased with Cyberleaf's reception by the press and our customers. Cyberleaf, a tool that makes Internet publishing easy, was conceived, developed and shipped in eight months. We also shipped Intellecte, an integrated document management system designed for rapid implementation and replication throughout an organization. In addition, the newly released Liaison product facilitates cross-platform integration and is expected to make Interleaf products even more attractive to system integrators and future alliance partners.

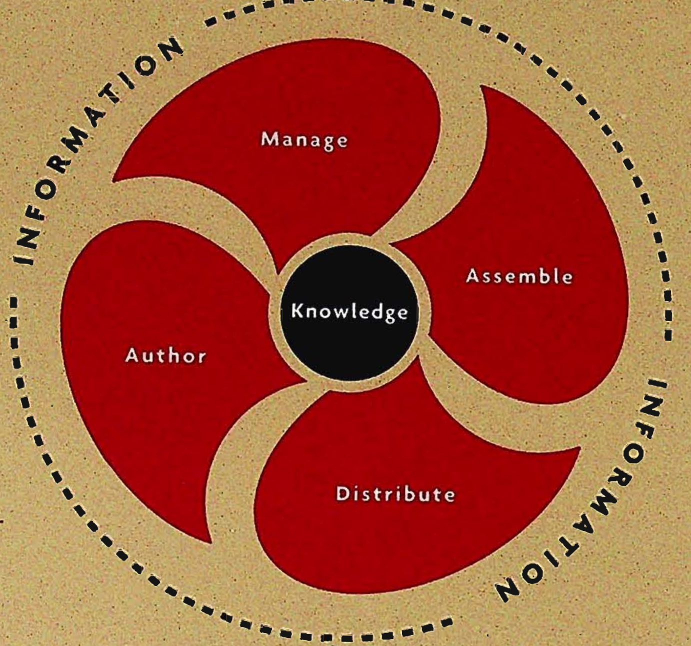
We expect the release of product enhancements and new products in fiscal 1996 to help in our return to profitable growth. Interleaf is also actively pursuing alliances with firms that complement our product and service offerings. For example, as part of our ongoing relationship with Microsoft, we developed and are maintaining that company's SGML Author for Word product. We've already begun operational improvements in sales and marketing worldwide to more successfully bring new products to market, using both a direct and alternate channel approach. In Europe, the Interleaf organizational structure is now Pan-European, moving away from a country-oriented structure. This enables us to be more flexible and cost-efficient by better leveraging our resources across the region. And after a successful test in the United Kingdom, we are implementing an aggressive vertical marketing strategy worldwide. The new structure and focus on vertical markets is expected to help us achieve better penetration of targeted industries while providing greater support for multinational firms.

So what does the future hold for Interleaf? The good news is that Interleaf's market is experiencing dynamic growth. Leading industry analysts at International Data Corporation predict the total document management software market will grow to almost $4.5 billion by 1998. With the industry's most experience and expertise, and the most comprehensive product line for information and document management solutions, Interleaf is uniquely positioned to take advantage of the exploding market. There is an Interleaf product to support each stage of the document management lifecycle, from authoring to distribution. Over the years, we have helped thousands of organizations worldwide overcome their most daunting document and information management issues, resulting in one of the most loyal customer bases in the industry. In fact, creating this industry's largest and most experienced document consulting team has allowed us to tackle some of the most complex and varied document management problems for our customers.

In closing, we are committed to returning to and maintaining profitability during the new fiscal year. The infrastructure has been put in place to achieve positive revenue growth in product sales, maintenance renewals and services. We will devote significant effort to developing alliances and leveraging distribution channels. Our products will be delivered on a predictable schedule and we will increase our product offering to broaden market appeal. Finally, we are totally focused on being the best provider of publishing and document management products and services to help our customers build business solutions that turn information into a competitive advantage.

Ed Koepfler
President and Chief Executive Officer

Meeting the need for electronic publishing and document management solutions

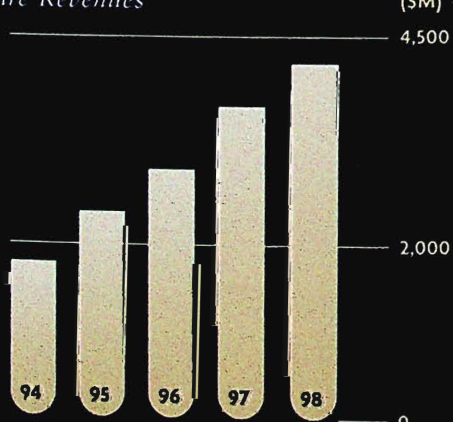


Document Management Lifecycle

The demand for electronic publishing and document management solutions is growing rapidly as firms increasingly recognize the importance of documents. Every major business process – from research and development to sales – is document-driven. By gaining control over the document lifecycle, a firm can leverage its knowledgebase of strategic document information to its best advantage. Ultimately, the right solution can provide the edge needed to stay ahead of the competition.

The first step toward building a solution is to understand the document lifecycle. There is no such thing as a "typical" lifecycle because documents are produced, used and re-used in an endless variety of ways. However, most documents go through four major stages: authoring, management, assembly and distribution. Having a strategy for managing all phases of the document lifecycle is the only way to leverage the full value of the knowledgebase.

Projected Document Management Software Revenues



Source: Document Management Software Market Review and Forecast, 1994; International Data Corporation

Interleaf combines expertise with open, integrated technology to minimize the cost and risk of building a document information management system. Interleaf products and services can be used to streamline the electronic publishing process or to build comprehensive document management solutions for firms facing even more demanding challenges. Only Interleaf document management solutions provide these advantages: comprehensive support for all stages of the lifecycle, multiple language and platform support, integral workflow and compound document technology. These advantages position Interleaf as the best choice for organizations that want maximum value from their knowledgebase.

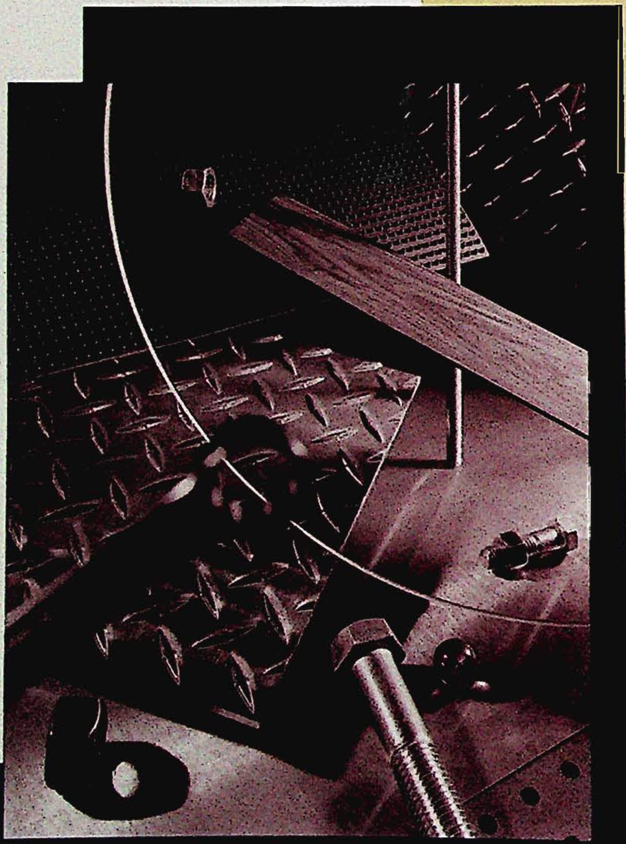
"Interleaf is uniquely positioned to maintain and grow its dominance in the document management market due to its participation throughout the entire lifecycle of a document."

Linda Myers-Tierney, Analyst
International Data Corporation

The most comprehensive electronic publishing solutions

Information and documents are vital to business processes. Not having the right publishing tools to meet deadlines or make last-minute changes to business-critical documentation can keep products from shipping or planes from taking off.

Interleaf publishing solutions boost productivity by automating the phases of the document lifecycle, from authoring to assembly to distribution. Ultimately, Interleaf enables firms to realize significant benefits: the ability to produce documents faster, more accurately and at lower cost.



Customized solutions that work in the real world

One of the greatest challenges facing organizations is how to manage the document lifecycle when multiple authors must collaborate across diverse network environments. Interleaf publishing tools increase productivity and help workgroups keep efforts synchronized. Over the years, firms have used Interleaf publishing solutions for virtually every kind of business-critical process. For instance, R&D departments have used Interleaf to speed the assembly and approval of requirement, functional and design specifications, reducing product development time and cost. Manufacturers have delivered accurate parts lists, material specifications and assembly instructions online to the factory floor for increased product quality and faster time to market. Sales representatives have shortened the sales cycle with push-button access to the most current price lists, proposals and product data sheets.

SCHÜCO International
Bielefeld, Germany

SCHÜCO International is the European leader in the manufacture of innovative windows, doors and facade systems.

"At SCHÜCO, we view documentation as a vitally important communications vehicle that's critical to our success. Interleaf let us cut the time needed to produce our order and manufacturing catalog by 70 percent, achieving a significant cost reduction. As a result of this very good experience, we will continue to place our full confidence in Interleaf in the future."
– Hans-Ulrich Esdar, Manager of Technical Documentation

Support for workgroup productivity and international standards

Interleaf provides the electronic publishing tools authors need to transform raw information into the full range of documents – from memos and charts to multi-volume documentation sets of great length and complexity. Robust, automated authoring and assembly capabilities expedite the access and re-use of information from any source, speeding document creation. Documents can be built using any variety of data objects, including word processing files, CAD drawings and spreadsheets. The difficulties of integrating varied data objects into a single document or document collection are eliminated with Interleaf Avalanche conversion tools.

Interleaf also provides unparalleled authoring support for workgroup environments, helping authors and reviewers collaborate across any number of sites, technologies and time zones. Specialized tools let organizations comply with industry standards such as SGML and ISO 9000.

Getting information to the people who need it

Interleaf distribution solutions enable organizations to deliver online or printed documentation that meet the most exacting standards of quality and presentation. WorldView lets firms distribute electronic documents and document collections across networks or on CD-ROM, providing instant access to business-critical information across any number of platforms, operating systems and hardwares. Cyberleaf provides a comprehensive production environment for distributing information to the World Wide Web, making it easier than ever before to leverage the possibilities of the information superhighway.

IMS International
Nanterre, France

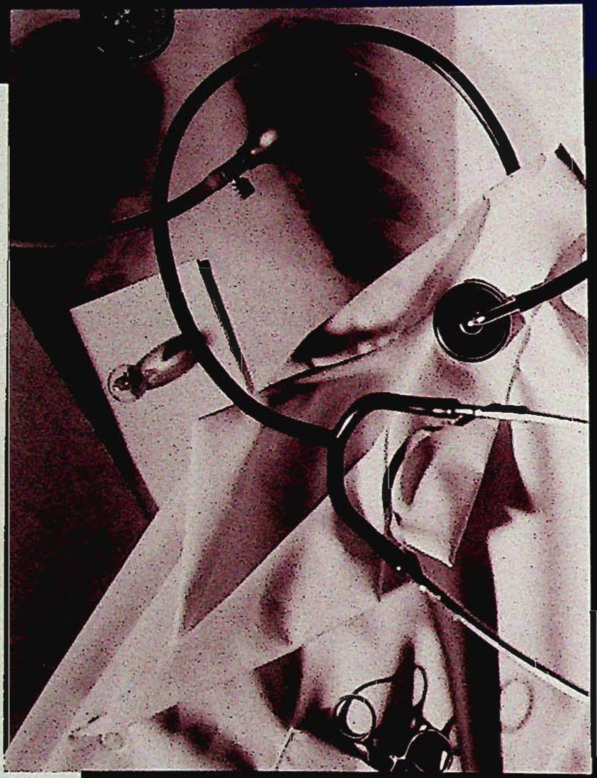
IMS International is the leading worldwide provider of information services for the pharmaceutical industry.

"Choosing Interleaf's information management solution was a strategic decision for IMS. Interleaf's technology will speed our time to market, allowing us to leverage our most precious asset: our business-critical information." – Patrick Rambaud, General Manager of IDRAC division

The BMJ Publishing Group
London, England

The BMJ Publishing Group publishes learned journals and books specializing in the medical field.

"After an extensive investigation of various systems, the BMJ Publishing Group, the publishing division of the British Medical Association, selected an Interleaf system for electronic data capture, production and text management. Interleaf clearly understood our needs and provided an SGML-capable system that will greatly facilitate information re-use. This strategy will enable the BMJ Publishing Group to make the transition from a publisher of paper-dependent products to being a true multi-format information provider." – Derek Parrott, Production Director



Meeting the need for document management solutions

An organization's knowledgebase of strategic document information is one of its most valuable assets. Many firms invest heavily in producing and maintaining information in document form, often using a wide variety of software packages to do so. High-value information gets isolated in separate document files and scattered across the organization. Failure to control its knowledgebase can seriously jeopardize a firm's competitive edge.

Beyond electronic publishing

Many firms face document lifecycle requirements that demand more than electronic publishing tools. They need a document management and distribution system that allows them to organize, track and access document-based information anywhere on their network. With Interleaf Intellecte, firms can implement document management solutions that manage documents as databases of text and graphics that can be created, revised, distributed, annotated, printed, stored and re-used within increasingly heterogeneous computing environments. By consolidating the assembly, management and distribution processes of the document lifecycle into an automated

"Our just-completed research confirms that Interleaf is the leader in the fastest growing segment of the document management market."

Frank Gilbane, CAP Ventures
The Gilbane Report

document information management system, organizations improve the quality of their documents and reduce the time spent manually creating, tracking and distributing documents to multiple reviewers and users.

Competitive advantage through document-based information

In any industry, effective document management is key to sustaining a competitive advantage. Manufacturers that must meet ISO 9000 guidelines, for instance, use Interleaf's automated revision history and audit trail capabilities for error-proof compliance. Interleaf solutions help pharmaceutical firms get drugs to market faster by automating the entire new drug application process, no matter how many revisions, updates, contributors and source technologies are involved.

These are just a few examples. Whatever the requirements, Interleaf document management solutions enable firms to streamline the most demanding and business-critical document-based information processes.

Solutions that grow with customer needs

All Interleaf document management solutions are based on an open architecture, so they can support even the most diverse networking environments. Automated integration of different technologies boosts productivity by enabling workers to concentrate on core business processes instead of the logistics of making different platforms "talk" to one another. Workers locate, share, track and re-use documents and information throughout the lifecycle, no matter how many different kinds of data objects and platforms are in use. In addition, Interleaf solutions can be customized at any point to accommodate emerging standards and technologies.

Unisys Corporation
Roseville, Minnesota, USA

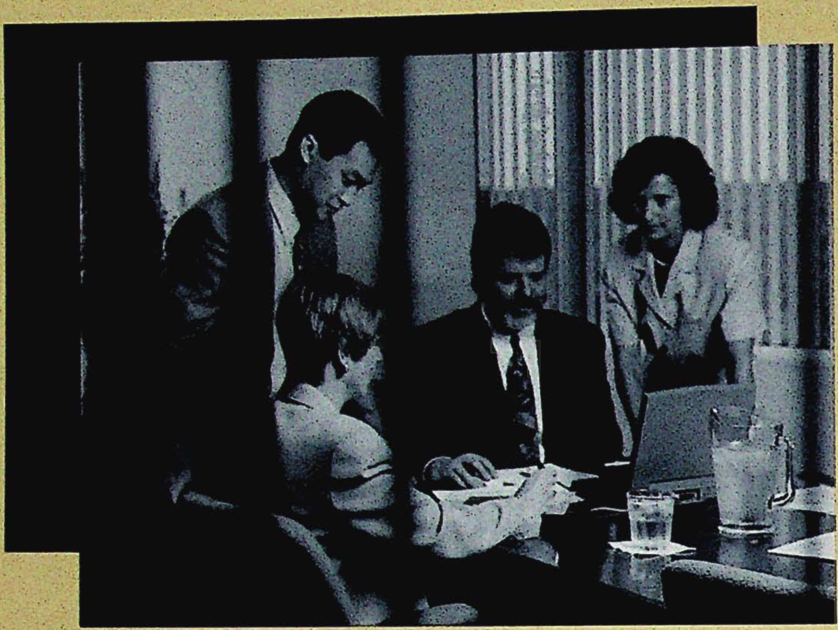
Unisys Corporation is a major manufacturer of mainframe computers.

"Our partnership with Interleaf has been a key to our success in meeting documentation deadlines. The solid solution provided by Interleaf and the Avalanche product line has reduced the time it takes to deliver both printed and online documentation. This has resulted in a 304 percent return on our investment." – Deb Peterson, Senior Product Information Analyst

Fujitsu Limited
Tokyo, Japan

Fujitsu Limited is one of the largest computer and systems integration vendors in the world.

"Every month we update thousands of customers on product information, everything from OS updates to patch releases. In the past we've distributed this as a large volume of paper that's expensive and difficult to produce and keep accurate. With Interleaf, we can put everything online. It's more efficient to update and ship information on CD-ROM, and easier for customers to find the information they need." – Kazunori Yoshida, UNIX Support Project Manager



Software, service and support for control over the document management lifecycle

Building a comprehensive solution for all stages of the document management lifecycle is the best way to transform an organization's knowledgebase of information into a competitive advantage. Interleaf Professional Services Group (IPSG) is the world's largest and most experienced consulting team dedicated to building document management solutions. IPSG offers a full range of services, from customization and integration to document process re-engineering. Interleaf also provides comprehensive training, maintenance and support services to help organizations anywhere in the world keep their document management solutions on track.

In addition, Interleaf is the only vendor to meet the demand for a low cost, low risk, integrated document management solution. Interleaf Intellecte is a comprehensive document management application, combined with services and a proven methodology, that enables users to implement a basic document management and distribution system in as little as twelve weeks.

Streamlining document processes results in major benefits, including faster time to market, improved product and service quality, increased productivity and reduced cost. With the industry's greatest range of products and services, Interleaf is ideally positioned to help organizations around the world leverage their most valuable asset: their knowledgebase.

Pierre Fabre
Paris, France

Pierre Fabre is a major pharmaceutical laboratory.

"Interleaf's technology will enable us to save several months on New Drug Applications submissions. We chose Interleaf because of its strong, integrated solutions and the extensive support and services provided locally." – Jean-François Mézil, Information System Manager; Dr. Yves Mainguy, Project Leader

The financial statements, including all related financial information presented in the Annual Report, were prepared by management, and management is responsible for their fairness, integrity and objectivity. These statements have been prepared in accordance with generally accepted accounting principles, include amounts that are based upon management's best estimates and judgement and incorporate accounting policies that are reasonable and prudent for the Company's business environment. The financial statements have been audited by our independent public accountants, Ernst & Young LLP, and their report is included elsewhere herein.

The Company maintains accounting and control systems that are subject to modification based upon recommendations from Ernst & Young LLP. Management believes the internal control systems in use are sufficient to provide reasonable assurance that assets are safeguarded against material loss and are properly accounted for, and that transactions are properly recorded in the financial records used in preparing the financial statements.

The Company has distributed throughout the organization its policies for financial control. Management believes that its policies and the monitoring of compliance with these policies provide reasonable assurance that its operations are adhering to prescribed financial policy.

The Board of Directors carries out its responsibility for these financial statements through its Audit Committee, composed of nonemployee Directors. The Audit Committee reviews the financial statements before they are released for publication. The Committee meets periodically with the senior financial officers and Ernst & Young LLP. It reviews the audit scope, significant financial transactions, major accounting issues and recommendations of Ernst & Young LLP. Ernst & Young LLP has full and free access to the Audit Committee and meets with its members, with and without management being present, to discuss internal control, auditing and financial reporting matters.

Ed Koepfler
President
and Chief Executive Officer

G. Gordon M. Large
Executive Vice President
and Chief Financial Officer

(in thousands except for per share amounts) **Year ended March 31**	**1995 a**	**1994 b**	**1993**	**1992 c**	**1991**
Total revenues	$ 87,856	$111,229	$117,341	$100,299	$ 84,318
Net income (loss)	(48,362)	(8,448)	9,303	5,984	(1,278)
Net income (loss) per share	(3.47)	(0.63)	0.55	0.38	(0.11)
Shares used in computing net income (loss) per share	13,938	13,384	16,836	15,704	11,956
Total assets	50,793	96,884	99,519	87,573	71,711
Long-term obligations	625	1,565	1,857	2,559	3,048
Total shareholders' equity	10,615	56,632	63,126	52,108	44,731
Common stock outstanding	14,203	13,631	13,064	12,434	12,065

a. Fiscal 1995 results include a $17.2 million charge for the write-down of intangible assets, a $7.1 million charge for restructuring of the Company's worldwide operations, and a $1.9 million charge for revaluation of the Company's deferred tax asset.

b. Fiscal 1994 results include a $4 million charge 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.

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

Results of Operations

Overview: During 1995, significant changes in the management team, operations and cost structure of Interleaf were made in an effort to position the Company to compete more effectively in its markets.

In the first quarter of fiscal 1995, the Company experienced a significant decline in revenue from the prior fiscal quarter which resulted in a loss of $8.2 million. During the second fiscal quarter, changes in the management team began and a corporate-wide restructuring was initiated, for which the Company recorded charges of $7.1 million to cover the cost of terminating employees and the reduction of facilities. Headcount was reduced 25%, from 895 employees at the end of fiscal 1994, to 674 at the end of fiscal 1995. Facilities were reduced by closing or consolidating 19 sales offices. As a result of the restructuring program, cost savings are expected to be $13–15 million per year. The Company also recorded a charge of $1.9 million related to a revaluation of its deferred tax asset. In the fourth quarter, in conjunction with the fiscal 1996 business planning process, the new management team completed a strategic and operational review of the Company's distribution channels, sales and marketing processes, investments in new product development, customer support operations and the internal systems requirements to sustain and grow the Company. As a consequence of this review and resulting changes in business practices and strategies, the Company evaluated the carrying values of its assets in light of its new business model. This evaluation resulted in a write-down of goodwill relating principally to certain non-U.S. operations of $15.2 million. The Company also wrote-off $3.2 million of capitalized software costs for projects discontinued in the fourth quarter or for which revenue projections no longer adequately support the capitalized amounts. Additional information on these events is discussed below and in notes 3 and 7 to the consolidated financial statements.

As a result of management's actions discussed above, revenues have remained relatively constant since the second fiscal quarter of 1995. Management's plan for 1996 is to achieve profitability during the second half of the year based on conservative revenue growth projections and the realization of the full benefits from the restructuring program.

COMPARISON OF FISCAL 1995 TO 1994

Revenues: Total revenues were $87.9 million, representing a decrease of $23.4 million, or 21%, from 1994. During this period, software product revenue declined $26.3 million, or 43%, to $34.6 million from $60.9 million in 1994. Partially offsetting this decline was a $3 million, or 15%, increase in services revenue.

The decline in software products revenue primarily resulted from reductions in sales of the Company's sophisticated document creation products (Interleaf 5 and 6) reflecting saturation for high-end publishing products in the aerospace/defense market and the lack of an effective reseller distribution channel to penetrate other market segments. Also contributing to this decline was the delayed shipment of products which support the Windows operating environment. Overall, 1995 sales of document creation products decreased by approximately $19.1 million from 1994.

Revenue for the Company's document management (RDM) and document distribution (WorldView) products also declined by $7.2 million from 1994, primarily due to prolonged proof-of-concept projects and, to some degree, to a disruption in the long selling cycles required for these complex products created by the Company's restructuring program.

Also contributing to the decline in the Company's product revenues was the lack of large multi-year procurements in 1995 as the Company began changing its business practices and strategies, as discussed above, and the marketplace saturation discussed above. In 1994, these orders represented approximately 20% of product revenue.

Maintenance revenue, consisting of providing telephone support and upgrades to the Company's software products, remained stable at approximately $31 million for each of the years 1995 and 1994. This is largely attributable to renewals from large, long-term customers primarily in the aerospace/defense industry. The services businesses, which include consulting and training, improved as a result of price increases and an increased demand for the Company's expert services to implement document management solutions. The Company expects these services will help leverage software product sales in the future.

Revenues from the Company's international operations declined to 35% of total revenues in 1995 from 38% in 1994, primarily due to a $12.9 million decline in software products revenue. This decline was partially offset by increases in maintenance and services revenues of $1.2 million.

Costs and Expenses: Costs of products increased primarily due to amortization of capitalized software development costs, which increased slightly from fiscal 1994, and a $1.2 million write-down of certain capitalized software development costs to net realizable value. The write-down was largely attributable to revenue projections which no longer adequately supported the remaining capitalized amounts. Also contributing to the high costs of products was fixed overhead costs and certain time-based royalty agreements. Maintenance costs decreased due to reduced headcount from the Company's restructuring program. Cost of services declined $1 million even though there was a $3 million increase in services revenues. This is largely attributable to improved operational effectiveness primarily related to increased utilization of consultants and price increases put into effect in the second quarter of fiscal 1995.

Selling, General and Administrative (SG&A) expenses decreased $3.7 million from 1994. This decrease began in the third quarter of fiscal 1995 and resulted primarily from the Company's restructuring program which reduced headcount and facility costs in these areas.

Research and Development (R&D) reflects the Company's continued investment in new and improved products. Total expense was $16.9 million, or 19% of revenues in 1995 compared to $17.3 million, or 16% of revenues in 1994. During 1995, the Company developed and began shipping Intellecte, Cyberleaf and WorldView for Japanese, all new products. In the second fiscal quarter of 1996, the Company expects to ship its Windows-based publishing products.

The write-down of intangible assets, discussed above, included costs primarily related to the unamortized balance of goodwill of $15.2 million which was incurred in the Company's acquisitions of its exclusive distributors in Germany, France and Canada. Also included in the write-down of intangible assets was approximately $2 million of capitalized software development costs, which was largely attributable to the Company's decision in the fourth quarter of fiscal 1995 to discontinue development work to port its publishing products to the Windows 3.1 operating system, a 16-bit operating system, in order to concentrate on development efforts related to the Windows 95 and Windows NT operating systems, which are 32-bit operating systems.

Net Loss: In addition to the items discussed above, 1995 results of operations were negatively impacted by the decision to provide a 100% valuation reserve on a deferred tax asset of $1.9 million. This asset, which pertained to anticipated benefits to be derived from research and development tax credit carryforwards, was recorded in fiscal 1994 as a result of the Company's adoption of SFAS No. 109, "Accounting for Income Taxes," and was fully reserved when an analysis of the Company's actual and anticipated operating results indicated that utilization of this asset was less likely than that required by SFAS No. 109.

COMPARISON OF FISCAL 1994 TO 1993

The Company incurred a net loss of $8.4 million in fiscal year 1994 on revenues of $111.2 million. This loss included a $4 million charge related to the acquisition of Avalanche Development Company and a $3 million restructuring charge, as well as a $1.9 million credit related to the Company's adoption of SFAS No. 109, "Accounting for Income Taxes." In fiscal year 1993, the Company earned $9.3 million on revenues of $117.3 million.

Revenues: Total revenues in 1994 declined $6.1 million, or 5%, from 1993 revenues of $117.3 million. This decline was nearly all related to the reduction in software product sales.

In 1994, the Company's publishing product, Interleaf 5 had a major decline in revenue of $15 million from 1993; the decline was primarily attributable to the decline of purchases by the aerospace/defense sector, historically the Company's largest customer base and the lack of an effective reseller distribution channel. This significant revenue decline was only partially offset by the strong revenue growth in the Company's document distribution (WorldView) and document management (RDM) products which increased $9 million during 1994.

The Company's maintenance business remained stable as revenues totalled $30.7 million for 1994 compared with $30.9 million in 1993.

The Company's services revenues, which include consulting and training, totaled approximately $19.6 million in 1994 and were relatively constant compared with 1993.

Costs and Expenses: Costs of services were $20.6 million and increased approximately $3 million, or 16%, from 1993. The increased expense was attributable to establishing the services' infrastructure (people and methodology tools) to adequately support anticipated growth and to leverage the integrated document management systems business.

Selling, General and Administrative expenses increased by approximately $3 million over 1993. This increase 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 increased its level of investment in research and development as expenses grew by $1 million over 1993 levels. The percentage of revenues utilized in this activity increased to 16% in 1994 from 14% in 1993. This is due to the Company's increased support for all major workstations, in most of the major geographical markets and to begin the development process to port its core creation products to the Windows operating system.

The Company recorded a restructuring charge in September 1993 to consolidate operations and reduce headcount by approximately 50 people, primarily in Canada and Germany. This action generated savings of $4 million per year.

Also during the year, a $4 million charge was incurred, representing purchased research and development costs, arising from the acquisition of Avalanche Development Company.

Net Loss: In addition to the items discussed above, 1994 results of operations were impacted by the Company's adoption of 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. This amount represented the Company's estimate of research and development tax credit carryforwards that it considered probable of realization based upon anticipated levels of federal taxable income over the next several years, which was within the expiration of the carryforward period. As a result, the Company had a net loss of approximately $8.45 million in 1994 compared with net income of $9.3 million in 1993.

Liquidity and Capital Resources

The Company ended the year with $10.4 million of cash and cash equivalents. Of this amount, $1.8 million was designated to liquidate collateralized capital lease obligations. These lease obligations were liquidated in April 1995. This cash position was significantly below the prior year's ending balance of $23.4 million and was the result of the poor profit performance in 1995, capital expenditures and the costs incurred for the restructuring program, which required approximately $5.6 million of expenditures related to severance and facility closings. The Company's cash position was favorably impacted during the year as a result of better receivable collections. The Company's days sales outstanding (DSO) improved by over 20%, from 109 days at March 31, 1994 to 86 days at March 31, 1995. The Company incurred $4.8 million of capital expenditures in 1995, down from $5.2 million in 1994. In fiscal 1996, the amount of capital expenditures will be significantly lower. Excess cash, as available, is invested in short-term money market funds having a maturity of less than 90 days.

In May 1995, the Company obtained a revolving line of credit of up to $10 million from a major commercial lender. The credit agreement limits borrowing based on certain financial criteria and contains restrictive covenants which are discussed in Note 4 to the consolidated financial statements. When the agreement was signed, the amount available for borrowings was approximately $5.2 million.

Management believes the Company's current cash position and borrowing availability are sufficient to sustain planned operations throughout fiscal 1996. In addition, as the result of a comprehensive 1996 business planning process, management has identified interim revenue objectives which, if not substantially met, will generate spending reductions adequate to sustain operations throughout the year.

The Company's capital requirements beyond fiscal 1996 will be determined by management's relative success in implementing its strategic and operating vision. Typically, profitable software companies are able to generate sufficient cash from operations to meet moderate growth requirements. Should operating results warrant the need for additional financing, such financing may be sought from financial institutions, the capital markets or strategic partners.

(in thousands except for per share amounts)

Year ended March 31	1995	1994	1993
REVENUES			
Products	$ 34,602	$ 60,924	$ 66,752
Maintenance	30,652	30,725	30,923
Services	22,602	19,580	19,666
Total revenues	87,856	111,229	117,341
COSTS OF REVENUES			
Products	10,878	9,640	8,516
Maintenance	6,178	6,918	6,391
Services	19,605	20,577	17,665
Total costs of revenues	36,661	37,135	32,572
Gross margin	51,195	74,094	84,769
OPERATING EXPENSES			
Selling, general and administrative	55,283	58,958	55,831
Research and development	16,855	17,332	16,302
Charge for purchased research and development	–	3,985	–
Write-down of intangible assets	17,173	–	–
Restructuring expense	7,109	3,000	–
Total operating expenses	96,420	83,275	72,133
Income (loss) from operations	(45,225)	(9,181)	12,636
Other expense	(1,019)	(749)	(1,007)
Income (loss) before taxes and cumulative effect of change in accounting principle	(46,244)	(9,930)	11,629
Provision for income taxes	2,118	418	2,326
Income (loss) before cumulative effect of change in accounting principle	(48,362)	(10,348)	9,303
Cumulative effect of change in accounting principle-accounting for income taxes	–	1,900	–
Net income (loss)	$(48,362)	$ (8,448)	$ 9,303
INCOME (LOSS) PER SHARE			
Income (loss) before cumulative effect of change in accounting principle	$ (3.47)	$ (.77)	$ .55
Cumulative effect of change in accounting principle	–	.14	–
Net income (loss)	(3.47)	(.63)	.55
Shares used in computing income (loss) per share	13,938	13,384	16,836

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

(In thousands except for share and per share amounts) March 31	1995	1994
Assets		
CURRENT ASSETS		
Cash and cash equivalents	$ 10,441	$ 23,364
Accounts receivable, net of reserve for doubtful accounts of $1,953 in 1995 and $1,169 in 1994	22,766	34,932
Prepaid expenses and other current assets	2,122	2,506
TOTAL CURRENT ASSETS	35,329	60,802
Property and equipment, net	11,058	11,034
Intangible assets	3,801	21,622
Other assets	605	3,426
TOTAL ASSETS	$ 50,793	$ 96,884
Liabilities and Shareholders' Equity		
CURRENT LIABILITIES		
Accounts payable	$ 2,687	$ 3,200
Accrued expenses	16,193	18,197
Unearned revenue	15,649	14,626
Other current liabilities	5,024	2,664
TOTAL CURRENT LIABILITIES	39,553	38,687
Other liabilities	625	1,565
TOTAL LIABILITIES	40,178	40,252
Contingencies		
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 1,728,573 in 1995 and 1,785,715 in 1994 (liquidation value $7 per share)	173	179
Common stock, par value $.01 per share, authorized 30,000,000 shares, issued and outstanding 14,203,027 in 1995 and 13,630,657 in 1994	142	136
Additional paid-in capital	67,382	65,551
Retained earnings (deficit)	(57,269)	(8,907)
Cumulative translation adjustment	187	(327)
TOTAL SHAREHOLDERS' EQUITY	10,615	56,632
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 50,793	$ 96,884

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, 1992	$214	$124	$61,682	$ (9,762)	$(150)	$52,108
Net income	–	–	–	9,303	–	9,303
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)
Balances at March 31, 1993	193	131	63,507	(459)	(246)	63,126
Net loss	–	–	–	(8,448)	–	(8,448)
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)
Balances at March 31, 1994	179	136	65,551	(8,907)	(327)	56,632
Net loss	–	–	–	(48,362)	–	(48,362)
Conversion of Senior Series B Convertible Preferred stock into common stock	(6)	1	5	–	–	–
Common stock issued in connection with incentive stock options exercised by employees	–	2	660	–	–	662
Common stock issued in connection with employee stock purchase plan	–	2	1,167	–	–	1,169
Common stock issued in connection with warrants exercised	–	1	(1)	–	–	–
Equity adjustment for foreign currency translation	–	–	–	–	514	514
Balances at March 31, 1995	$173	$142	$67,382	$(57,269)	$ 187	$10,615

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands) Year ended March 31	1995	1994	1993
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	$(48,362)	$ (8,448)	$ 9,303
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Cumulative effect of change in accounting principle	–	(1,900)	–
Charge for purchased research and development	–	3,985	–
Write-down of intangible assets	17,173	–	–
Restructuring expense	7,109	3,000	–
Depreciation and amortization expense	12,188	10,544	11,714
Loss from disposal of property and equipment	261	153	137
Deferred income taxes	1,860	89	402
Changes in assets and liabilities, net of effects from company purchased:			
(Increase) decrease in accounts receivable, net	13,550	(2,641)	(2,380)
Decrease in other assets	(610)	(676)	(1,075)
Increase (decrease) in accounts payable and accrued expenses	(3,188)	3,314	1,056
Increase in unearned revenue	439	1,052	971
Decrease in other liabilities	(5,333)	(2,092)	(522)
Other, net	(385)	(41)	62
Net cash provided by (used in) operating activities	(5,298)	6,339	19,668
CASH FLOWS FROM INVESTING ACTIVITIES			
(Increase) decrease in marketable securities	–	4,070	(4,070)
Capital expenditures	(4,827)	(5,232)	(4,569)
Capitalized software development costs	(3,831)	(4,064)	(4,034)
Payment for company purchased, net of cash acquired	–	(5,342)	–
Net cash used in investing activities	(8,658)	(10,568)	(12,673)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net proceeds from issuance of common stock	1,831	2,035	1,811
Property and equipment financing	682	1,375	1,794
Repayment of long-term debt and capital leases	(1,819)	(2,254)	(2,374)
Net cash provided by financing activities	694	1,156	1,231
Effect of exchange-rate changes on cash	339	35	(51)
Net increase (decrease) in cash and cash equivalents	(12,923)	(3,038)	8,175
Cash and cash equivalents at beginning of year	23,364	26,402	18,227
Cash and cash equivalents at end of year	$ 10,441	$23,364	$26,402

See Notes to Consolidated Financial Statements.

Note 1 Summary of Significant Accounting Policies

Principles of Consolidation	The consolidated financial statements include the accounts of Interleaf, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Interleaf, Inc. and its subsidiaries are collectively referred to as the "Company."
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 a software license includes insignificant obligations, 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. The Company recognizes revenue only when collection of payments is more than reasonably assured. Revenue is not recognized if payments are due more than one year from the balance sheet date. Maintenance revenues are recognized ratably over the contract period or as the services are performed. Services revenues are primarily recognized as the Company successfully performs the obligations specified under agreements with its customers on either a time and material basis or as contract phases are completed. Unearned revenue represents the remaining amount of revenue to be recognized in future periods primarily related to maintenance and service contracts. 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 and Cash Equivalents	Cash equivalents, consisting primarily of bank notes, commercial paper and treasury bills, represent highly liquid investments with maturities at date of purchase of three months or less. At March 31, 1995, the Company has approximately $1.8 million of cash designated to liquidate capital lease obligations.
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. The estimated useful lives generally range from 3 to 5 years. Expenditures for repairs and maintenance are charged to operations as incurred.
Intangible Assets	Intangible assets include the excess of the purchase price over the fair market value of the net assets of the acquired business (goodwill) and capitalized software development costs. Goodwill is amortized over periods ranging from 15 to 25 years. The Company continually evaluates whether events or changes in circumstances have occurred that indicate the remaining estimated useful life of goodwill should be revised or that the remaining balance may not be recoverable. 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 included in product costs of revenue 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 Company continually compares the unamortized portion of capitalized software development costs of a product to the net realizable value of that product. The net realizable value is the estimated future gross revenues from that product reduced by the estimated future costs of completing and disposing of that product. The amount by which the unamortized capitalized costs exceed the net realizable value is written-off. See Note 3 for discussion of Intangible Asset write-downs that occurred during the year ended March 31, 1995.
Foreign Currency Translation	The translation of assets and liabilities of foreign subsidiaries is made at year-end rates of exchange, and revenues and expenses 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.
Income (Loss) Per Share	Per share amounts are calculated using the weighted average number of common shares and common share equivalents outstanding during periods of net income. Common share equivalents are attributable to stock options, common stock warrants and convertible preferred stock. Per share amounts are calculated using only the weighted average number of common shares outstanding during periods of net loss. Fully diluted earnings per share is not materially different from reported primary earnings per share.
Basis of Presentation	Certain 1993 and 1994 amounts have been reclassified to conform to the 1995 method of presentation.

Note 2 Property and Equipment

Property and equipment at March 31 consisted of the following:

(in thousands)	1995	1994
Office, demonstration and other equipment	$29,492	$27,577
Development equipment	12,753	11,147
Furniture	4,766	4,455
Leasehold improvements	823	701
	47,834	43,880
Less allowances for depreciation and amortization	36,776	32,846
	$11,058	$11,034

Note 3 Intangible Assets

During the year ended March 31, 1995, the Company recorded a write-down of intangible assets principally associated with goodwill and capitalized software development costs. The charge to write-down goodwill was approximately $15.2 million primarily related to the Company's acquisitions in prior years of its exclusive distributors in Canada, France, and Germany. During fiscal 1994, these subsidiaries began to experience declines in profitability. To improve the profitability of its international operations, the Company implemented a restructuring program in September 1993. The Company's operations continued to perform below expectations during fiscal 1995. Further headcount and consolidation of facilities were implemented in these subsidiaries as part of the Company's worldwide restructuring program in the second quarter of fiscal 1995 (see Note 7). In conjunction with the fiscal 1996 planning process, the Company's new management team completed a strategic and operational review of all operations. As a consequence of this review, management determined in the fourth quarter of fiscal 1995 that there was a permanent impairment in the Company's carrying value of its goodwill. This was based on the continued deteriorating operating results in Canada, France, and Germany; the need to recapitalize certain of these subsidiaries; and an assessment that the factors which contributed to the valuations at the time of the respective acquisitions were no longer in evidence. The Company discounted the expected future cash flows from these subsidiaries and determined that the goodwill had no future value.

The charge to write-down capitalized software development costs and related other assets was approximately $3.2 million. Of this total, $2 million was primarily related to the cancellation of software development projects associated with the Company's decision to discontinue development efforts related to the Windows 3.1 16-bit operating system to concentrate on development for the Windows 95 and Windows NT 32-bit operating systems. The remaining $1.2 million write-down to net realizable value, included in product costs of revenue, related to revenue projections which no longer adequately supported the capitalized amounts associated with certain older software products.

Goodwill, net of amortization, was zero and $15,435,000 at March 31, 1995 and 1994, respectively. The unamortized portion of capitalized software development costs was $3,801,000 and $6,187,000 at March 31, 1995 and 1994, respectively. Amortization and write-down to net realizable value of capitalized software development costs was approximately $5,261,000, $3,870,000, and $3,671,000 for the years ended March 31, 1995, 1994, and 1993, respectively.

Note 4 Debt

In May 1995, the Company obtained a committed, revolving line of credit of up to $10 million. The credit agreement also provides for the issuance of letters of credit of up to $2 million. Borrowings from the line of credit bear interest at the higher of 9% or prime rate plus 2% and are secured by substantially all domestic assets of the Company. Outstanding letters of credit bear interest at 2%. Borrowings under the credit agreement are based upon the level of eligible North American accounts receivable, modified by the previous quarter's cash collections. When the agreement was signed, the amount available for borrowings was approximately $5.2 million. The agreement contains certain financial covenants relating to the Company's current ratio, tangible net worth, and working capital, as well as restrictions on certain additional indebtedness, acquisitions, capital expenditures, and dividend payments.

Note 5 Accrued Expenses

Accrued expenses at March 31 consisted of the following:

(in thousands)	1995	1994
Accrued compensation and related items	$ 4,785	$ 6,418
Royalties	2,351	2,311
Rent	1,927	2,332
Other	7,130	7,136
	$16,193	$18,197

Note 6 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. Rent expense amounted to $9,449,000, $9,356,000, and $9,725,000 for the years ended March 31, 1995, 1994 and 1993, respectively. 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, 1995, the cost of these assets was $6,401,000 of which $3,857,000 has been amortized. The Company failed to meet certain operating covenants under certain of its capitalized leases and has received a waiver for the period ended March 31, 1995. The Company has subsequently liquidated approximately $1.6 million of the outstanding balance. Future minimum rental payments at March 31, 1995 under agreements classified as operating and capital leases with non-cancellable terms in excess of one year are as follows:

(In thousands) **Years ending March 31**	**Operating Leases**	**Capital Leases**
1996	$ 7,192	$1,704
1997	6,464	20
1998	6,021	6
1999	4,967	–
2000	4,045	–
Thereafter	3,148	–
Total minimum lease payments	$31,837	1,730
Less amount representing interest (interest rates range from 6–12%)		26
Present value of net minimum lease payments		$1,704

Note 7 Restructuring

Restructuring charges include costs associated with employee termination benefits and facility closures and related costs. Employee termination benefits include severance, wage continuation, notice pay and related fringe benefits. Facility closure and related costs include lease payments, lease buyout costs, disposal of property and equipment and related costs.

During the second quarter of fiscal 1995, as part of a Company reorganization and to reduce costs, the Company recorded a restructuring charge of approximately $7.1 million. The restructuring plan was to reduce worldwide employment and to consolidate sales offices in North America and Europe. The employment reduction primarily relates to the marketing, sales, general and administrative, and research and development groups. Approximately $4.6 million of the restructuring charge was for employee termination benefits and $2.5 million for facility closures and related costs.

During the year ended March 31, 1995, the Company paid approximately $4.4 million for employee termination benefits and $1.2 million for facility closures and related costs. As a result of the restructuring program, worldwide employment was reduced by approximately 150 people and 19 sales offices were consolidated. At March 31, 1995 accrued restructuring charges are approximately $3,343,000. Expenditures are anticipated to continue through the first half of fiscal year 1996 for employee termination benefits and until fiscal year 2000 for facility closures and related costs.

During the second quarter of fiscal 1994, the Company recorded a restructuring charge of approximately $3 million. The restructuring plan was to reduce employment by approximately 50 people and to consolidate 4 sales offices in North America and Europe. At March 31, 1994 approximately $1,085,000 was accrued related to this restructuring plan.

Note 8 Income Taxes

The provision for income taxes is composed of the following:

(In thousands)	1995	1994	1993
Current:			
Federal	$ –	$171	$1,149
State	–	50	230
Foreign	258	108	545
Total current	258	329	1,924
Deferred:			
Federal	1,860	35	298
State	–	54	104
Total deferred	1,860	89	402
	$2,118	$418	$2,326

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

(in thousands)	1995	1994	1993
Domestic	$(43,607)	$(4,184)	$10,416
Foreign	(2,637)	(5,746)	1,213
	$(46,244)	$(9,930)	$11,629

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

(in thousands)	1995	1994
Deferred tax assets:		
Net operating loss carryforwards	$13,453	$ 5,691
Tax credit carryforwards	6,950	5,724
Accrued rent	738	897
Reserve for doubtful accounts receivable, vacation and other accruals	475	583
Restructuring	888	137
Total deferred tax assets	22,504	13,032
Deferred tax asset valuation allowance	(20,594)	(8,922)
	1,910	4,110
Deferred tax liabilities:		
Research and development costs, net of amortization	(1,464)	(2,382)
Depreciation	(422)	(451)
Other	(24)	(19)
Total deferred tax liabilities	(1,910)	(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 are not considered probable of realization. The deferred tax asset valuation allowance increased by $11,672,000 for the year ended March 31, 1995 and by $2,282,000 from the adoption of SFAS No. 109 on April 1, 1993 to March 31, 1994. In the second quarter of fiscal 1995 the Company recorded an adjustment of approximately $1.9 million to the beginning of the year balance when an analysis of the Company's actual and anticipated operating results indicated, at that time, that utilization of the deferred tax asset was less likely than that required by SFAS No. 109.

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

(In thousands)	1993
Research and development costs, net of amortization	$111
Reserve for doubtful accounts receivable, vacation and other accruals	26
Inventory adjustments	(18)
Depreciation	8
Restructuring accrual less amounts for which no tax benefit was realized	161
Accrued rent	(169)
Deferred software revenue	291
Other, net	(8)
	$402

Note 8 Income Taxes (con't)

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)	1995	1994	1993
Computed at federal statutory rate	$(15,723)	$(3,376)	$3,954
State income taxes, net of federal tax benefit	–	33	152
Nondeductible amortization	397	385	341
Purchased research and development	–	1,355	–
Nondeductible write-downs	5,021	–	–
Other nondeductible expenses	101	61	40
Loss for which no tax benefit was realized	9,051	2,131	207
Other temporary differences for which no tax benefit was realized	1,262	–	–
U.S. and foreign tax rate difference	123	–	187
Adjustment to beginning of the year deferred tax asset valuation allowance	1,860	–	–
Benefit of net operating loss carryforward	–	(153)	(807)
Benefit of tax credits	–	–	(1,776)
Other, net	26	(18)	28
	$ 2,118	$ 418	$2,326

At March 31, 1995, the Company and its subsidiaries had net operating loss carryforwards of approximately $34.9 million that are available to offset future taxable income. The loss carryforwards are attributable to 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 $6.9 million available to reduce future federal and state income tax liabilities through the year 2008. During the years ended March 31, 1995, 1994 and 1993, the Company made zero, $48,650, and $1,530,000 in income tax payments, respectively.

Note 9 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.

Note 9 Shareholders' Equity (con't)

The Series B holders can convert each share of preferred stock into 1.34375 shares of common stock. Series B holders converted 57,142, 142,857, and 214,285 shares of Series B Convertible Preferred Stock into shares of the Company's common stock during fiscal 1995, 1994, and 1993, respectively.

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.

The Company has issued warrants to purchase the Company's common stock in connection with various research and development agreements and exclusive distribution agreements. In March 1995, 72,368 shares of common stock were issued in connection with the exercise of a warrant. At March 31, 1995, warrants to purchase 692,178 shares of common stock at an exercise price of $5.21 were outstanding.

At March 31, 1995, approximately 6,300,000 shares of common stock were reserved for issuance.

Stock Option Plans: The Company has stock option plans that provide for the granting of non-qualified and incentive stock options to employees, consultants, and officers. The Board of Directors determines the option price, the option term, and the vesting period. Incentive stock options are granted at a price not less than the fair market value on the date of grant. On July 14, 1994, the Board of Directors adopted the 1994 Employee Stock Option Plan which provides for a maximum of 750,000 shares of common stock to be issued and sold under the plan. On August 3, 1994, the Board of Directors authorized the repricing of approximately 746,000 stock options and the cancellation and re-grant of approximately 297,000 stock options ranging in price from $4.00 to $19.38 to the fair market value of $2.75 on that date.

A summary of activity for these stock option plans is as follows:

(in thousands, except price range of shares)	Number of Shares	Price Range of Shares
Outstanding at March 31, 1992	1,422	$ .57 – $19.38
Granted	426	8.38 – 11.38
Exercised	(173)	.57 – 8.38
Cancelled	(142)	3.13 – 16.50
Outstanding at March 31, 1993	1,533	1.13 – 19.38
Granted	485	6.75 – 9.50
Exercised	(192)	1.13 – 7.50
Cancelled	(273)	3.13 – 15.87
Outstanding at March 31, 1994	1,553	1.13 – 19.38
Granted	1,574	2.75 – 7.25
Exercised	(216)	1.13 – 3.63
Cancelled	(951)	2.75 – 15.63
Outstanding at March 31, 1995	1,960	$2.75 – $10.75

At March 31, 1995, there were approximately 528,000 shares available for grant. Options exercisable were approximately 915,000, 916,000, and 650,000 at March 31, 1995, 1994, and 1993, respectively.

The Company also has stock option plans for non-employee directors. In September 1993, the Board of Directors approved, with subsequent ratification by the shareholders, the Company's 1993 Director Stock Option Plan. The 1993 Director Stock Option Plan replaced the 1989 Director Stock Option Plan. Options are granted at the fair market value at date of grant and are exercisable one year later. Each non-employee director received a grant of 5,000 options at the inception of the 1993 Director Stock Option Plan. Each newly elected non-employee director receives a grant of 5,000 options as of the first date of his or her election as a director. Every April 1, each non-employee director automatically receives a grant of 5,000 options. At March 31, 1995, there were options outstanding to purchase approximately 85,000 shares and approximately 95,000 shares were available for grant. Options exercisable were approximately 85,000, 36,000, and 30,000 at March 31, 1995, 1994, and 1993, respectively.

Employee Stock Purchase Plan: The Company's Employee Stock Purchase Plan allows eligible officers and employees to withhold up to 10% of their total compensation to purchase shares of the Company's common stock. The purchase price is 85% of the fair market value of the stock on the date a one year offering commences or the date an offering terminates, whichever is lower. Shares issued to employees were approximately 208,000, 182,000 and 156,000 for the years ended March 31, 1995, 1994, and 1993, respectively. At March 31, 1995, approximately 606,000 shares of common stock were reserved for issuance.

Note 10 Employee Benefit Plans

The Company's retirement savings plan (401(k) plan) allows eligible employees to make tax-deferred contributions. Participants in the 401(k) plan may contribute up to 20% of their total annual compensation, not to exceed the specified statutory limit. Participants are 100% vested in their own contributions. The 401(k) plan permits, but does not require, the Company to make contributions to the 401(k) plan. The Company made contributions of $100,000 during the year ended March 31, 1995; no contributions during the years ended March 31, 1994 and 1993.

Note 11 Research and Development Agreements

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. PruTech invested $2,950,000 in the Venture. The Company receives 65% of revenues from the sale of such products for expenses. 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. If any cash is available for distribution, 86% 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 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 using the DOS operating system. The Company recorded net revenues from the sale of joint venture products of approximately $400,000, $2,100,000, and $1,600,000 for the years ended March 31, 1995, 1994 and 1993, respectively.

In connection with the arrangement, PruTech has obtained a warrant to purchase 356,286 shares of the Company's common stock at a price of $5.21 per share through October 1995.

Note 12 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 the purchase price was allocated to the assets acquired and liabilities assumed based on their respective fair values as of the date of the acquisition. In connection with this acquisition, a 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.

Note 13 Contingencies

In the ordinary course of its business activities, the Company is subject to various investigations, claims and legal proceedings. Each of these matters is subject to various uncertainties, and it is possible that some of these matters may be resolved unfavorably to the Company. Management believes that the ultimate resolution of these matters will not have a material adverse effect on the financial position or results of operations of the Company.

Commencing in the third quarter of fiscal 1994, PruTech reviewed and audited the Venture. PruTech claims that it is entitled to mandatory cash distributions of 30% of the Venture's revenues, that certain Venture technology is being used by the Company without compensating the Venture, and that research and development expenses incurred by the Company above PruTech's original investment should not be allocated to the Venture. In March 1994, PruTech submitted this dispute to mandatory arbitration on which no significant proceedings have occurred. While the dispute has not been resolved, the Company believes that PruTech's position is without merit and, in any event, believes that the outcome will not have a material adverse effect on the financial position or results of operations of the Company.

Note 14 Industry Segment and Geographic Information

The Company operates in a single industry segment supplying software and custom solutions to be used for document information management.

Information regarding geographic areas at March 31, 1995, 1994 and 1993, and for the years then ended is as follows:

(In thousands) **March 31, 1995 and for the year then ended**	U.S.	Non-U.S.	Eliminations	Total
Sales to unaffiliated customers	$ 56,853	$31,003	$ –	$ 87,856
Intercompany royalties and transfers	7,076	18	(7,094)	–
Net revenues	63,929	31,021	(7,094)	87,856
Income (loss) from operations	(35,538)	(9,687)	–	(45,225)
Identifiable assets	61,679	18,877	(29,763)	50,793
March 31, 1994 and for the year then ended	**U.S.**	**Non-U.S.**	**Eliminations**	**Total**
Sales to unaffiliated customers	$ 68,529	$42,700	$ –	$111,229
Intercompany royalties and transfers	12,008	–	(12,008)	–
Net revenues	80,537	42,700	(12,008)	111,229
Income (loss) from operations	(3,919)	(5,262)	–	(9,181)
Identifiable assets	107,661	21,945	(32,722)	96,884
March 31, 1993 and for the year then ended	**U.S.**	**Non-U.S.**	**Eliminations**	**Total**
Sales to unaffiliated customers	$ 72,840	$44,501	$ –	$117,341
Intercompany royalties and transfers	10,889	–	(10,889)	–
Net revenues	83,729	44,501	(10,889)	117,341
Income (loss) from operations	10,935	1,701	–	12,636
Identifiable assets	109,275	20,360	(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, 1995 and 1994, 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, 1995. 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, 1995 and 1994, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 1995, in conformity with generally accepted accounting principles.

Ernst + Young LLP

Boston, Massachusetts
May 11, 1995

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1995 and 1994 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 1995					
Revenues	$ 19,240	$ 23,011	$ 21,824	$ 23,781	$ 87,856
Gross margin (a)	10,781	13,931	12,493	13,990	51,195
Net income (loss)	(8,153)	(14,556) b	(5,782)	(19,871) c	(48,362)
Net income (loss) per share	(.59)	(1.05)	(.41)	(1.41)	(3.47)
Common stock prices					
High	7 1/2	4 7/8	4 5/8	6	7 1/2
Low	5	2 1/2	3 1/4	2 7/8	2 1/2
Close	5 1/4	4 3/8	3 1/2	4 7/8	4 7/8
FISCAL 1994					
Revenues	$ 27,184	$ 26,679	$ 28,415	$ 28,951	$111,229
Gross margin (a)	18,260	17,275	18,998	19,561	74,094
Income (loss) before cumulative effect of change in accounting principle	(4,968) d	(6,062) f	40	642	(10,348)
Net income (loss)	(3,068) d, e	(6,062) f	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
Close	8 5/8	6	7 5/8	6 3/4	6 3/4

Notes to Supplemental Financial Information

a. Amortization of capitalized software development costs previously classified as operating expenses has been reclassified to cost of revenues to conform with the 1995 method of presentation.

b. Includes a $7.1 million charge for restructuring of the Company's worldwide operations and a $1.9 million charge for revaluation of the Company's deferred tax asset.

c. Includes a $17.2 million charge for the write-down of intangible assets.

d. Includes a $4 million charge for acquired research and development in connection with the acquisition of Avalanche Development Company in June 1993.

e. Includes a $1.9 million benefit upon adoption of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," effective April 1, 1993.

f. Includes a $3 million charge for restructuring of the Company's worldwide operations.

g. The Company has never paid cash dividends. The Company is restricted from paying cash dividends during the term of the credit agreement.

h. The Company's common stock is traded on the over-the-counter market and is quoted on the NASDAQ National Market System under the symbol LEAF. On May 31, 1995, there were 1,150 holders of record of the Company's common stock. This number does not reflect persons or entities who hold their stock in nominee or "street name" through various brokerage firms.

Corporate Officers

Ed Koepfler
President and Chief Executive Officer

Frederick J. Egan
Vice President, Asia/Pacific/Japan

Paul English
Senior Vice President,
Product Management

Stephen J. Hill
Vice President, Europe

Bob Maher
Vice President, Technology

Mark H. Cieplik
Vice President, Americas

G. Gordon M. Large
Executive Vice President and
Chief Financial Officer

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

Ed Koepfler
President and Chief Executive Officer
Interleaf, Inc.

George D. Potter, Jr.
President
Quality Systems International

Patrick J. Sansonetti
Senior Vice President
Advent International Corporation

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 17, 1995 at 8:30 a.m. at the Westin Hotel, 70 Third Avenue, Waltham, 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
Investor Relations
Mail Stop: 45-02-09
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 LLP
Boston, MA

Legal Counsel
Hale and Dorr
Boston, MA

Corporate Directory

Corporate Headquarters
Interleaf, Inc.
Prospect Place
9 Hillside Avenue
Waltham
Massachusetts
02154 USA

SALES OFFICES

United States
El Segundo, Redwood Shores, California; Boulder, Colorado; Atlanta, Georgia; Oakbrook Terrace, Illinois; Greenbelt, Maryland; Waltham, Massachusetts; Irving, Texas

Canada
Ottawa, Ontario

International
Melbourne, Sydney, Australia; Brussels, Belgium; Paris, France; Frankfurt, Hamburg, Munich, Germany; Milan, Italy; Tokyo, Japan; Madrid, Spain; Stockholm, Sweden; Montreux, Zurich, Switzerland; London, U.K.

Copy
Dana Finnegan
Interleaf Investor Relations

Evelyn Walsh

Design
Pam Simonds
Interleaf Marketing Communications

Photography
Ian Tuck

This annual report is printed on recycled paper.