

Interleaf

Annual Report

1997



With the growth of the Internet, intranets and information services around the globe, today's businesses are deluged with information from a variety of sources. The difference between success and failure is often the ability to effectively manage and utilize this information to the company's advantage.

At Interleaf, we help companies around the world access, enhance, and share vital business information from the full spectrum of information sources. This information may come from word processing documents, graphic applications, spreadsheets, corporate databases and, increasingly, electronic transmissions from e-mail to Internet documents. Interleaf helps companies manage, publish and distribute information from these different sources through its integrated document management and

Interleaf manages and publishes knowledge

enterprise active publishing solutions with real results. An independent study by International Data Corporation found Interleaf customers have experienced returns on investment (the interest rate a corporation receives from an investment) of 96% to 410% from their Interleaf document management and publishing applications.

With a history of innovation and customer success, Interleaf is a leader in providing publishing solutions for business-critical information. Over two-thirds of the Global 1000 rely on Interleaf solutions for their document management and publishing needs. Companies count on us to help them increase their product quality, lower costs, shorten time to market, and increase profitability. In short, provide all the tools and support they need to leverage the power of information.

WE'RE EVOLVING OUR PRODUCT



LINES AND BUSINESS APPROACH TO



LEVERAGE OUR STRENGTH IN



DELIVERING THE NEXT GENERATION



OF ENTERPRISE PUBLISHING SOLUTIONS.

a new Leaf

Interleaf is sharpening its focus in a highly competitive and changing technical world. One of the reasons customers have always turned to Interleaf for document management and publishing solutions is our experience and understanding of the market. Today the sweeping changes created by the Web, corporate intranets, and the growing need to disseminate information in multiple forms present a whole new publishing opportunity. That's why we're evolving our product lines and business approach to leverage our strength in delivering the next generation of enterprise publishing solutions. These are the types of solutions that companies need to publish and distribute complex, "active" documents on a large scale.

Document management and publishing is changing just as the definition of a document itself is changing. A document is no longer just a communication of text and graphics, but more and more frequently includes active information. This new active document is a composite of dynamically changing text, data, graphics, video clips, sound and multimedia. And the proliferation of active documents demands more advanced publishing solutions—the types of enterprise-wide active solutions for large companies that Interleaf is uniquely qualified to provide.

In addition, corporate intranets are driving the need for improved document management and publishing solutions. According to CAP Ventures, an independent research and consulting firm, the overall level of intranet spending will approach \$8.5 billion in 1997—more than double 1996 spending. CAP Ventures also projects that customers intend to spend much more on development and integration services in 1997—a market segment projected to grow 171%, from \$660 million in 1996 to nearly \$1.8 billion in 1997.

At Interleaf, we're re-positioning our organization to meet the changing demands of this growing publishing-centric market. With our integrated document management and enterprise active publishing applications, we're enabling users to take advantage of converging technologies to manage and distribute information more efficiently and effectively.





Interleaf is a company in transition. With new management, a new direction, and new opportunities before us, we are rebuilding the company and laying the groundwork for the company's return to profitability.

These changes are already underway, but are still too new to be reflected in the company's fiscal 1997 performance. For the fiscal year ended March 31, 1997, Interleaf reported revenues of \$64.8 million, down from \$88.6 million in fiscal 1996.

Since my arrival at the company in January 1997, I have put together a new senior management team with the specific skills and experience needed to guide the company through this important transition. Working with our customers, partners, industry analysts and employees, we have examined Interleaf's strengths and weaknesses, the dynamics of the marketplace, and the company's core competencies to begin the rebuilding process. As you might imagine, we are closely managing expenses and operations to improve our efficiency and cost-effectiveness. But more importantly, we are simplifying, refocusing, and getting back to the competencies that first made Interleaf the industry's leading publishing and document management solution.

As you may know, Interleaf began by providing enterprise and complex, technical document publishing systems to customers. Today, our customers still rely on Interleaf as their publishing solution for creating and distributing information across their internal and extended enterprises. What has changed however, is the entire publishing paradigm.

Internet technology in the form of company intranets is becoming the new enterprise networking infrastructure. As companies begin to implement these systems, they are looking for complete solutions to the management and distribution of enterprise information.

moving

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forward

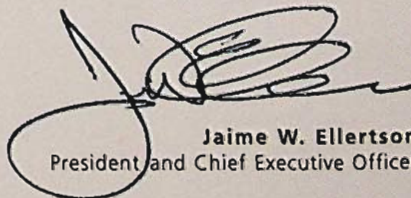
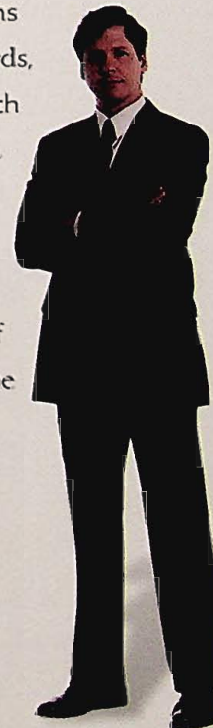
The solutions increasingly need to integrate information from a variety of sources and formats to meet specific or individualized needs. The information must be distributed or published when and where demanded to print, CD-ROM, and to corporate intranets or external Webs. The documents are becoming more complex and often include "active" information such as from live data feeds which are constantly changing. All of these active documents demand more advanced publishing solutions.

This is enterprise active publishing. This is our core strength, and our greatest opportunity:

To capitalize on this opportunity, we have refocused our development teams to build new products that support new computing platforms, new standards, and the new publishing paradigm. We are moving quickly and decisively with solutions designed specifically to meet the evolving needs of our customers. We are inviting new partnerships by shifting to more open platforms and products for more universal solutions.

This coming year, Interleaf will announce new product initiatives that build on our acknowledged core competencies. We will integrate with best of breed products from industry partners, and deliver new solutions to meet the publishing needs of today's extended enterprise.

This year, I fully expect that you will begin to see the results of our efforts. I thank you for your support, and I look forward to building on Interleaf's heritage of excellence as we return to profitability and growth.



Jaime W. Ellertson
President and Chief Executive Officer



Enterprise publishing is increasingly an integral part of document management. The documents that need to be accessed and managed are often those that must be distributed, or published, for a wide audience across the enterprise. But enterprise publishing is much more than shifting from paper to electronic delivery. It may mean e-mailing documents to a geographically dispersed project team, distributing via the Web or intranet—or even allowing the reader to control the flow and configuration of information to interactively access just what's needed for a particular business project. For today's companies, the ability to simultaneously publish to multiple electronic formats is often a requirement to remain competitive.

Interleaf gives companies these capabilities and more. Our focus is on enterprise active publishing and distribution for the complex, information-rich document market. Companies from healthcare to finance depend on Interleaf solutions to instantly publish information from their own databases so their documents are always up to date.

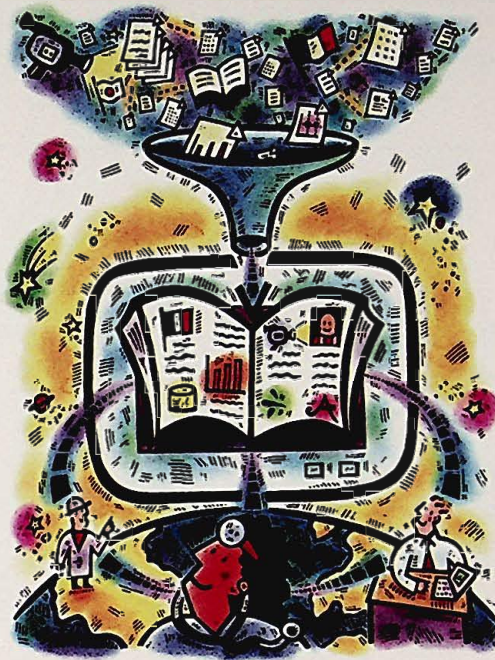
We provide the ability to compile a document with information from multiple sources from people around your office, around the country, or around the world and integrating it all into a complete, consistent, formatted document. We enable users to easily change one part of a document so the changes ripple through hundreds of other linked documents. We provide the ability to integrate and customize documents quickly and easily to take advantage of a company's information assets on a broad scale.

Specifically, our focus is on markets including enterprise publishing and re-use/re-purposing, as well as integrated database publishing, demand print, and Web publishing. And because no two companies are exactly the same, we provide the ability to customize our enterprise active publishing solutions for the individual needs and environment of each user.

"Standard and Poor's business is providing timely, accurate information. By working with Interleaf, we've developed and adopted an enterprise-wide system for managing our information and streamlining our publishing, which has resulted in measurable improvements in efficiency and effectiveness. Interleaf has provided the expertise and full-scale capabilities we've needed to manage and distribute our information faster and better than ever."

Ken Moskowitz
CIO—Standard and Poor's





creating a web that really works

"By putting our product documentation online with Interleaf's automated publishing tools, we've accelerated the dissemination of knowledge to our customers, while strengthening the productivity of our technical staff."

Ken Peterson
Electronic Publishing Manager
MacNeal-Schwendler Corporation

Internet, intranet and general Web technologies are fueling the rapid growth of the document management and publishing market. Web browser penetration worldwide is expected to exceed 200 million units by the year 2001, and the number of intranet-focused Web servers is projected to reach 1.1 million, according to International Data Corporation.

Today companies are not just managing information over the Web, but also distributing it that way. You could say the Web is becoming the new backbone of document management and publishing.

Interleaf is the leader in Web-accessible integrated document management solutions. We offer software and services solutions that leverage Interleaf document management and delivery systems by adding Internet access to the information people want to see and use. Information can be distributed any number of ways—in the Internet markup language, HTML; as an electronic viewing file such as our WorldView System; or as a Java viewing application.

Unlike a traditional Web page that's time consuming to maintain and requires constant attention and updates, our solutions tie directly to the underlying information at the source—in the document management environment. So the Web page never becomes another repository full of out-of-date information. There aren't the problems of processing thousands of documents that must be constantly revised, and synchronized with other delivery and publishing processes. And there's no gap between the release of information, and updating your Web site.

With Interleaf, companies can leverage Web technology with a document management infrastructure at a lower cost and with far less maintenance than a disconnected Internet delivery system. Users get a friendly, easy-to-use interface that hides the complexity of accessing and merging diverse information from multiple sources. And by creating a dynamic, virtual Web, users always get the latest, up-to-date information they need to make more effective business decisions.

a l l k i n d s o f i n f o r m a t i o n

f r o m a l l k i n d s o f s o u r c e s



an integrated document management and enterprise active publishing system needs to manage large volumes of information from increasingly diverse sources—and publish to a variety of file formats. Because documents may include various types of images, audio clips or multimedia presentations, these varied files are stored in different storage vessels, or repositories, often at different locations.

At Interleaf, we help our customers integrate all this information—and make it all work together. Since companies today use multiple repositories, our document management and publishing solutions access and publish to many different types of files and formats.

A key feature of our Interleaf solution is an open, scalable, integrated repository. It enables users to locate, control and distribute up-to-the-minute information



from a multitude of sources. It helps companies readily access and manage the dispersed information that's critical to their business success. And it provides careful tracking of revisions and approvals, so users always know when and where changes were made.

"Keeping up with the documentation requirements for a seemingly endless array of products presented a tremendous challenge—a challenge met with a just-in-time assembly and distribution solution using Interleaf technology."

Todd E. Jones
Documentation Tools Support and
Development Manager
Northern Telecom

Our document management and publishing systems mirror business processes enabling users to streamline the tasks of managing and effectively utilizing documents wherever they come from. With the added functionality Interleaf offers, we make managing information a faster, easier, more efficient process. And we help companies work

more effectively to achieve their business objectives.

Looking ahead, as the types of repositories continue to grow, we will continue to work toward the most open systems possible to provide ready access and publishing capabilities for the information our customers need.

t h e p r o d u c t s o f a b e t t e r s o l u t i o n

a successful document management and publishing solution is the result of a range of products working successfully together. That's why our products combine the benefits of integrated document management, enterprise active publishing and the Internet, supported by the expertise to provide a total solution.

Unlike other products, Interleaf solutions manage the entire document life-cycle—from work-in-process to completion to re-use. The life of the document begins as individuals create content with any number of word processing, graphics, audio, video, or authoring tools. Because large documents often have a multitude of authors or are assembled from diverse sources, we provide a powerful work-group application, *Interleaf 6*, that enables local or global collaboration, making it easier and more efficient to share information and manage projects.

With our *RDM Document Management System*, the work flow is automatically routed through the creation, revision, and review cycle. Documents can be distributed online for edits, comments or approvals. In addition, Interleaf *Liaison* enables organizations to build and customize document management solutions for specific environments and simplifies integration across the network.

Once a document is finalized, it may be stored in a repository where it is accessible to people across the extended enterprise. It can be converted into an HTML file for viewing on the Web with our award-winning Internet publishing application. An employee in New York

might use Interleaf for instant access to the document, or utilize our electronic viewing application *WorldView* which enables viewing from virtually any computing environment. Or a sales representative in London may choose to *Demand Print* the document to paper.

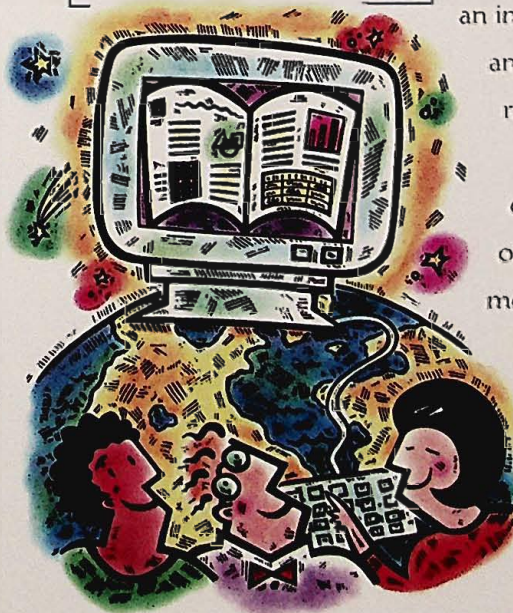
When the document is updated, our *Production Manager* automation tool can be used to automatically notify all users of the document that a new version is available, ensuring timely and current information distribution.

These solutions are available through an integrated mix of Interleaf products and services for leveraging document resources across the enterprise.

As we evolve our company to compete more effectively by developing superior document management and distribution products, we are focusing our efforts on creating a more open architecture for increasingly universal solutions.

"The HomeWEB strategy has become a de facto standard at McDonnell Douglas and has produced a fundamental cultural shift in the creation, distribution, and use of information within the company."

Robert Scheurer
Senior Project Engineer
McDonnell Douglas Corp.



f r o m o u t - o f - t h e - b o x ,

t o o u t - o f - t h e - o r d i n a r y



Interleaf's integrated document management and enterprise active publishing products can work right off the shelf. However, the complex challenges of large companies require much more than off-the-shelf answers. That's why Interleaf is the only company to offer the full range of products and services required to implement a true document management solution to fully leverage business-critical information.

We have one of the largest, most comprehensive groups of consultants, service and support personnel in the document management industry. Through the Interleaf Professional Services Group (IPSG), we bring in-depth technical and industry expertise to every tailored solution we provide. With hundreds of expert consultants worldwide, IPSG services range from system analysis and design, to on-site implementation and customization for special requirements within a vertical market solution.

For organizations such as financial services, utilities, pharmaceutical companies, telecommunications firms, and aerospace and manufacturing enterprises, IPSG delivers a full range of services to quickly gain an advantage in managing business-critical documents. Each solution is implemented using our proven software development and project management methodology to ensure our customers' success.

Interleaf also has more than 14 education centers around the world offering courses and workshops to provide relevant, hands-on training and invaluable learning and insight. Our training specialists offer standard, customized, and industry-specific programs to help our customers maximize the return on their investment in our technology. In addition, we offer comprehensive, award-winning telephone and online support.

In an industry rapidly changing, those document management companies that will succeed are those that can offer the products and solutions to help their customers stay one step ahead. At Interleaf, we understand what today's and tomorrow's document systems must do to make information more accessible, manageable and useful. That's why we're refocusing and simplifying our products and plans to strengthen our market position, backed by a heritage of expertise and insight no other company can match. Just as importantly, we believe we have the people, resources and partners to enable us to evolve our products to deliver the next generation of integrated document management and enterprise active publishing solutions.

We look forward to the
challenge ahead.

f i n a n c i a l i n f o r m a t i o n



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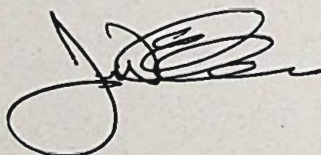
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The financial statements, including all related financial information presented in the Annual Report, were prepared by management, and management is responsible for their fairness, integrity and objectivity. These statements have been prepared in accordance with generally accepted accounting principles, and include amounts that are based on management's best estimates and judgment 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.

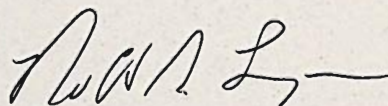
The Company maintains accounting and control systems that are subject to modification based on recommendations from Ernst & Young LLP. Management believes the internal control systems in use are sufficient to provide reasonable assurance that assets are safeguarded against material loss and are properly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

The Company has communicated 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.



Jaime W. Ellertson
President
and Chief Executive Officer



Robert R. Langer
Vice President, Finance and Administration
and Chief Financial Officer

selected five-year financial data

(in thousands except for per share amounts)

Year ended March 31	1997 a	1996 b	1995 c	1994 d	1993
Total revenues	\$ 64,823	\$88,557	\$ 87,856	\$111,229	\$117,341
Net income (loss)	(29,550)	311	(48,362)	(8,448)	9,303
Net income (loss) per share	\$ (1.70)	\$ 0.02	\$ (3.47)	\$ (0.63)	\$ 0.55
Shares used in computing net income (loss) per share	17,344	18,495	13,938	13,384	16,836
Total assets	\$ 37,900	\$48,916	\$ 50,793	\$ 96,884	\$ 99,519
Long-term obligations	2,955	733	625	1,565	1,857
Total shareholders' equity	\$ (772)	\$15,419	\$ 10,615	\$ 56,632	\$ 63,126
Common stock outstanding	17,459	16,698	14,203	13,631	13,064

- a. Fiscal 1997 results include \$10.9 million of restructuring charges for restructuring of the Company's worldwide operations, a \$2.3 million write-off of intangible assets, and a \$2.5 million write-off of capitalized software, inventory and prepaid royalties.
- b. Fiscal 1996 results include a \$1.2 million benefit from the settlement of a long-term dispute with a joint venture partner.
- c. Fiscal 1995 results include a \$15.2 million write-off of goodwill related to the acquisition of distributorships in Canada, France and Germany, a \$7.1 million charge for restructuring the Company's worldwide operations, a \$2.0 million write-off of capitalized software development costs, and a \$1.9 million charge for revaluation of the Company's deferred tax asset.
- d. Fiscal 1994 results include a \$4 million charge for acquired in-process 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.

management's discussion and analysis of

financial condition and results of operations

Results of Operations

Overview: The Company recorded a net loss of \$29.6 million on revenues of \$64.8 million in fiscal 1997. This compares with net income of \$0.3 million on revenues of \$88.6 million and a net loss of \$48.4 million on revenues of \$87.9 million in fiscal 1996 and 1995, respectively. Much of the decline in revenue for fiscal 1997 is due to a decrease in product revenue caused by the ongoing maturation of the market for complex authoring products which is a main product line at the Company. An effort to focus on developing and supporting integrated document publishing ("IDP") applications for the extended enterprise has been initiated.

As a result of the total revenue decline of 27% in fiscal year 1997 from fiscal year 1996, principally in software products, the Company underwent a comprehensive restructuring of facilities, fixed assets, and personnel during the year. The net loss of \$29.6 million for fiscal 1997 was due to the impact from the decline in product revenue, charges of \$2.3 million for the write-off of intangible assets from an early fiscal year 1997 acquisition, a \$2.5 million write-off of capitalized software, inventory and prepaid royalties, and charges of \$10.9 million for restructuring the Company's worldwide operations. In addition to the fiscal 1997 restructuring, the Company began installing a new senior management team, refocusing its business strategy, streamlining product offerings, and significantly reducing the cost structure of the Company.

REVENUES

Product: Total product revenue decreased by \$16.0 million or 46% in fiscal 1997 compared to fiscal 1996. Revenue declined in all geographic regions. Fiscal 1996 was level with fiscal 1995. The continuing trend in the reduction in product license revenue is due to several factors. The first negative trend is the decline in licensing of the Company's UNIX-based high-end authoring products which is primarily attributable to the increasing popularity of Windows-based publishing software, for which the Company did not have any offerings until fiscal 1996. A second factor is the saturation of UNIX-based high-end authoring software in the aerospace/defense industry, where the Company had historically derived most of its authoring product license revenue.

The Company is refocusing its business strategy on providing integrated document publishing (IDP) applications targeted toward specific vertical markets. While the Company has built well-accepted integrated document publishing based solutions for individual customers, it has not yet demonstrated the ability to develop, market and sell IDP applications. There is no assurance that the Company will be successful in implementing its strategy and, therefore, the Company is unable to predict if or when product revenues will stabilize or grow. Additionally, since the Company's services and maintenance revenue is largely dependent on new product licenses, these revenue components have also experienced downward pressure. This trend will continue unless product revenue stabilizes.

Maintenance: Maintenance revenue declined by \$3.3 million or 10% in fiscal 1997 from fiscal 1996, although it was relatively stable in fiscal 1996 and 1995. This relative stability, during a time of decreasing product licensing, was largely attributable to renewals from the Company's very large, long-term customers primarily in the aerospace/defense industry. Future maintenance revenue is dependent on the Company's ability to maintain its existing customer base and to increase maintenance contract volume related to the new IDP application sales. This will be necessary to offset the general downward pricing pressure on maintenance in the software industry and customers perceived value of maintenance services.

Services: Services revenue, consisting of consulting and customer training revenue, declined by \$4.5 million or 21% in fiscal 1997 compared to a decrease of \$1.1 million or 5% in fiscal 1996 from 1995. The Company leverages software product licenses with services to provide IDP solutions to its customers. During fiscal 1995, the Company worked on several large service projects which were completed during early fiscal 1996. The decline in fiscal 1997 and 1996 was primarily attributable to the decrease in product license revenues, a decrease in services personnel, and lower training revenue associated with the decline in authoring software product licensing. In fiscal 1997, consulting projects tended to be smaller with resultant lower margins due to lower utilization rates and there was no replacement of the large consulting projects completed in 1996 and 1995.

North America: Revenues were approximately \$41.8 million (64%), \$57.1 million (64%), and \$60.0 million (68%) of total revenues during fiscal 1997, 1996, and 1995, respectively. The decline in fiscal 1997 was primarily due to a decrease in product license and consulting revenues. The decline in fiscal 1996 was primarily due to a decrease in product license and training revenues.

International: Revenues from the Company's international operations were approximately \$23.0 million (36%), \$31.5 million (36%), and \$27.9 million (32%) of total revenues during fiscal 1997, 1996, and 1995, respectively. The decrease in fiscal 1997 was primarily due to declining product revenue compared to fiscal 1996. The increase in fiscal year 1996 from fiscal year 1995 was due to the growth in software site licenses or electronic distribution software licensing agreements in Europe and increased demand from resellers in Japan, partially offset by a decline in European service revenue.

Product license revenue in Japan is volatile because the Company distributes its products through a network of large credit-worthy resellers and integrators who typically enter into upfront fixed fee license agreements. Reorders in Japan are dependent on the success of the resellers and integrators in licensing the Company's products to end-user customers.

Fiscal 1998: During fiscal 1998, the Company plans to develop several Integrated Document Publishing ("IDP") application offerings which solve specific business problems in several industries. Growth in revenues during fiscal 1998 will be largely dependent on improving sales force productivity, the effectiveness of the Company's increased investment in marketing and lead generation programs, customer acceptance of the new and enhanced software products planned to be released in fiscal 1998 and the next year, and the Company's success in leveraging software products with services to provide IDP solutions to its customers. If the Company is unable to grow or stabilize its revenues in fiscal 1998, further expense reductions will be necessary in order to sustain operations.

COSTS OF REVENUES

Cost of product revenue includes amortization of capitalized software development costs; product media, documentation materials, packaging and shipping costs; and royalties paid for licensed technology. Cost of product revenue increased \$1.1 million or 16% in fiscal 1997 from 1996, compared to a decrease of \$6.4 million (50%) in

fiscal 1996 from 1995. Included in the cost of product revenue for fiscal 1997 and 1995, which was absent in fiscal 1996, were write-downs of \$2.0 million and \$3.2 million, respectively, of capitalized software development costs. This occurred as a result of a strategic product review by management and a decision to discontinue products and write-down old software products with limited future revenue potential. Additionally, in fiscal year 1997, there were write-offs of inventory and prepaid royalties. The cost of maintenance revenue decreased by \$0.6 million or 12% in fiscal 1997 from 1996, compared to a decrease of \$1.0 million or 16% in fiscal 1996 from 1995. Most of the decreases were related to a reduction in customer support personnel associated with the Company's 1997 and 1995 restructurings. The decrease in cost of services revenue of \$2.2 million or 12% in fiscal 1997 from 1996, compared to a decrease of \$1.3 million or 7% in fiscal 1996 from 1995, is primarily related to the downward trend in product revenue which results in less integration services.

OPERATING EXPENSES

Selling, General and Administrative (SG&A): SG&A expenses decreased \$5.6 million or 13% in fiscal 1997 from 1996, compared to a decrease of \$12.6 million or 23% in fiscal 1996 from fiscal 1995. The decline in SG&A expenses over the last two fiscal years was primarily due to significant personnel and facilities expense reductions related to the Company's fiscal 1997 and 1995 restructurings. Also contributing to lower SG&A expenses in fiscal 1996 was the settlement of a long-term dispute with a joint venture partner that resulted in a non-recurring expense reduction of approximately \$1.2 million (see Note 12 to the Consolidated Financial Statements for further discussion). Further SG&A expense reductions are anticipated throughout fiscal 1998 as the full benefit of the restructuring programs are realized. In addition, the Company will continue to manage SG&A expenses to keep costs in line with revenue.

Research and Development (R&D): R&D expenses consist primarily of personnel expenses to support product development offset by capitalized software development costs. R&D expenses decreased by approximately \$0.9 million (6%) in fiscal 1997 from 1996, compared to a decrease of approximately \$1.0 million (6%) in fiscal 1996 from fiscal 1995. The decreases in fiscal 1997 and 1996 were primarily due to reduced personnel expenses associated with the Company's fiscal 1997 and 1995 restructurings and, for fiscal 1996 versus 1995, increased capitalization of software development costs. During fiscal 1997, 1996, and 1995, R&D expenses were approximately 23%, 18%, and 19%, respectively, of total revenues. R&D spending, which excludes the offset for capitalized software development costs, represented approximately 24%, 23%, and 24% of total revenues, respectively. During fiscal 1997, the Company completed product enhancements across all of its major product lines. Functionality and additional platform support were added to Interleaf 6, WorldView, Intellecte/BusinessWeb, Liaison, and RDM in multiple localized releases for its North American, European and Asia/Pacific markets.

The Company's product development plans for fiscal 1998 call for a consolidation of many individual product lines into focused integrated enterprise publishing and distribution applications. The product strategy directly aligns with the corporate strategy to refocus its efforts on database enabled electronic publishing. As part of this effort, some existing products that no longer align with its focus will be retired and a number of new products will be developed to expand the Company's ability to capture sales in new departments of its Fortune 1000 customer base, or in mid-sized firms with high growth rates.

Restructuring and Other Charges: In fiscal year 1997, the Company incurred restructuring charges of approximately \$10.9 million, of which \$8.5 million related to the July and October 1996 restructurings. Additionally, there was a \$2.4 million charge recorded in the fourth quarter to reflect changes in cost and timing assumptions for previously restructured facilities. These restructuring initiatives were taken in an effort to realign the Company's cost structure with the Company's revenues, which declined throughout fiscal 1997. In addition, the Company recorded a charge of \$2.3 million to write-off intangible assets associated with the acquisition of The Learning Alliance (see further discussion in Liquidity and Capital Resources). The Company also recorded a \$2.5 million expense (of which \$2.2 million was recorded in the fourth quarter) for the write-off of capitalized software development costs, inventory, and prepaid royalties for discontinued products and products with limited revenue potential. In fiscal year 1995, the Company incurred restructuring charges of approximately \$7.1 million due to a worldwide reorganization and a reduction in the size of its operations. During the fourth quarter of fiscal 1995, the management team performed a strategic and operational review of the Company's sales and marketing processes, distribution channels, product development plans, and customer support operations. As a consequence of this review and associated changes in the Company's business strategy

and operations, the Company evaluated the carrying value of its long-lived intangible assets, principally goodwill and capitalized software development costs, which resulted in a write-down of approximately \$17.2 million.

INCOME TAXES

For fiscal year 1997, no tax provision was required due to the losses sustained during the year. In fiscal 1996, the effective tax rate was reduced by net operating loss carryforwards. Fiscal 1995 was negatively impacted by an adjustment to the beginning deferred tax asset valuation allowance of approximately \$1.9 million when an analysis of the Company's actual and anticipated operating results indicated, at that time, that the deferred tax asset established in fiscal 1994 was not expected to be realized.

The Company has net operating loss carryforwards of approximately \$60 million in several tax jurisdictions to offset future taxable income. In addition, the Company has tax credit carryforwards of approximately \$7 million to offset federal and state income tax liabilities. Therefore, the Company expects to pay minimal income taxes for the foreseeable future.

Liquidity and Capital Resources

The Company had approximately \$17.3 million of cash and cash equivalents at March 31, 1997, an increase of approximately \$4.6 million from March 31, 1996. The increase was primarily attributable to the net proceeds from the issuance of Senior Series C Preferred Stock of \$9.4 million and common stock issuances related to its stock option plans and employee stock purchase plan of approximately \$1.2 million. This increase was partially offset by payments of \$4.1 million related to the Company's restructurings and investments of \$1.1 million in capitalized software development costs. The Company also made investments of \$1.8 million in capital equipment, principally for improvements to the Company's information system infrastructure in fiscal 1997. Interleaf's German subsidiary, Interleaf GmbH, has been notified that it is liable for German withholding taxes related to payments remitted to the United States from Germany in 1990. The Company is appealing this assessment. At March 31, 1997 and 1996, the Company had approximately \$1.1 million of cash restricted for potential payment of German withholding taxes.

As part of the Company's former strategy to develop sales force automation and integration applications, the Company acquired The Learning Alliance, Inc. ("TLA") in May 1996 for 341,500 shares of common stock valued at \$2.7 million. In December 1996, in order to allow the Company's management to focus on development of its core businesses, the Company decided to divest itself of TLA. TLA was sold in January 1997 for future royalty considerations and foregone severance obligations. As a result of this decision, in December 1996, the Company recorded a \$2.3 million write-off of certain intangible assets which had been recorded in connection with the acquisition.

Restructuring accruals associated with both the fiscal 1997 and 1995 restructurings were approximately \$7.3 million at March 31, 1997 and \$1.3 million at March 31, 1996. Cash payments related to these restructurings, the majority of which are related to operating lease payments, net of subleases, are anticipated to continue until December 2000. All significant vacant space under lease has been subleased, or is the subject of a letter of understanding. Other future obligations at March 31, 1997, consist primarily of facility and equipment leases relating to the regular operations of the Company. In 1998, the Company expects to spend approximately \$700,000 in capital improvements and \$3.4 million in cash payments related to the restructuring accrual.

In May 1995, the Company obtained a revolving line of credit from a major commercial lender. Borrowings from the line of credit are secured by substantially all domestic assets of the Company. At March 31, 1997 and 1996, there were no loans outstanding under this line of credit. However, a letter of credit for \$0.8 million is issued and outstanding and, accordingly, the amount available for borrowings was approximately \$1.2 million (see Note 5 to the Consolidated Financial Statements regarding borrowing limits and restrictive covenants associated with the credit agreement). This agreement expires in August 1997 and negotiations are underway to establish a new credit facility. Management believes that they will be able to continue or replace the existing agreement by August 1997.

In addition to the sale of Series C Convertible Preferred Stock (see Note 10 to the Consolidated Financial Statements), the Company also, in November 1995, issued 190,000 shares of common stock associated with an agreement between the Company and a joint venture partner (see Note 12 to the Consolidated Financial Statements). The objective of the fiscal 1997 Series C financing was to enable the Company to generate sufficient cash flow to return to a sustainable profitable condition.

During 1997, the Company experienced a substantial decline in revenues and a substantial loss from operations, resulting in a shareholders' deficit at March 31, 1997. Due to the downward trend in the Company's revenues, the Company is unable to predict future revenues and when, or if, it will achieve a sustainable profitable level of operations. In response to these matters, the Company developed detailed plans relating to its fiscal 1998 operations which, if realized, will restore the Company to profitable operations. Although no assurances can be given that such plans will be achieved, management is committed to taking all appropriate and necessary actions to effect timely cost reductions in the event that anticipated revenue levels are not achieved. In the event such actions are not successful in achieving breakeven or profitable operations, additional financing will be needed. Under such circumstances, no assurance can be given that such financing could be obtained or that it could be obtained at commercially reasonable terms or without incurring substantial dilution to existing shareholders. The financial statements do not include any adjustments to reflect the possible effects of these uncertainties.

The Company believes its current cash balances and cash generated from operations will be sufficient to meet the Company's liquidity needs for fiscal 1998 and the foreseeable future. The Company can only fund its long-term growth through increasing revenues, combined with tightly managed cost controls.

Risk Factors

From time to time, information provided by the Company or statements made by its employees may contain forward-looking information. The Company's actual future results may differ materially from those projections or suggestions made in such forward-looking information as a result of various potential risks and uncertainties including, but not limited to, the factors discussed below.

The Company's future operating results are dependent on its ability to develop and market integrated document publishing software products and services that meet the changing needs of organizations with complex document publishing requirements. There are numerous risks associated with this process, including rapid technological change in the information technology industry and the requirement to bring to market IDP applications that solve complicated business needs in a timely manner. In addition, the existing document publishing, electronic distribution, and document management markets are highly competitive. Many of these competitors are larger and better funded than the Company. The Company competes for sales of its software products on both an individual product basis and integrated with services in large IDP solution sales.

Sales cycles associated with IDP solution sales are long because organizations frequently require the Company to solve complex business problems that typically involve reengineering of their business processes. In addition, a high percentage of the Company's product license revenues are generally realized in the last month of a fiscal quarter and can be difficult to predict until the end of a fiscal quarter. Accordingly, given the Company's relatively fixed cost structure, a shortfall or increase in product license revenue can have a significant impact on the Company's operating results and liquidity.

The Company markets its software products and services worldwide. Global and/or regional economic factors, currency exchange rate fluctuations, and potential changes in laws and regulations affecting the Company's business could impact the Company's financial condition or future operating results.

The market price of the Company's common stock may be volatile at times in response to fluctuations in the Company's quarterly operating results, changes in analysts' earnings estimates, market conditions in the computer software industry, as well as general conditions and other factors external to the Company.

c o n s o l i d a t e d s t a t e m e n t s o f o p e r a t i o n s

(in thousands except for per share amounts)

Year ended March 31

	1997	1996	1995
Revenues			
Products	\$ 18,821	\$34,786	\$ 34,602
Maintenance	28,972	32,281	30,652
Services	17,030	21,490	22,602
Total revenues	64,823	88,557	87,856
Costs of Revenues			
Products	7,502	6,443	12,866
Maintenance	4,561	5,179	6,178
Services	16,041	18,270	19,605
Total costs of revenues	28,104	29,892	38,649
Gross margin	36,719	58,665	49,207
Operating Expenses			
Selling, general and administrative	37,114	42,674	55,283
Research and development	14,994	15,875	16,855
Write-down of intangible assets	2,288	—	15,185
Restructuring charge	10,942	—	7,109
Total operating expenses	65,338	58,549	94,432
Income (loss) from operations	(28,619)	116	(45,225)
Other income (expense)	(931)	225	(1,019)
Income (loss) before income taxes	(29,550)	341	(46,244)
Provision for income taxes	—	30	2,118
Net income (loss)	\$(29,550)	\$ 311	\$(48,362)
Income (Loss) Per Share	\$ (1.70)	\$ 0.02	\$ (3.47)
Shares used in computing income (loss) per share	17,344	18,495	13,938

See Notes to Consolidated Financial Statements.

c o n s o l i d a t e d b a l a n c e s h e e t s

(in thousands except for share and per share amounts)

March 31

1997

1996

Assets

Current Assets

Cash and cash equivalents	\$ 17,349	\$ 12,725
Accounts receivable, net of reserve for doubtful accounts of \$1,371 in 1997 and \$1,695 in 1996	11,359	19,771
Prepaid expenses and other current assets	1,504	2,112

Total Current Assets	30,212	34,608
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Property and equipment, net	4,963	7,800
Intangible assets	2,281	6,164
Other assets	444	344

Total Assets	\$ 37,900	\$ 48,916
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Liabilities and Shareholders' Equity (Deficit)

Current Liabilities

Accounts payable	\$ 1,774	\$ 2,908
Accrued expenses	14,455	13,255
Unearned revenue	15,102	15,986
Accrued restructuring	4,386	615

Total Current Liabilities	35,717	32,764
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Long-term restructuring	2,955	733
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Total Liabilities	38,672	33,497
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Shareholders' Equity (Deficit)

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 861,911 in 1997 and 923,304 in 1996 (liquidation value \$7 per share)	86	92

Senior Series C convertible, issued and outstanding 1,006,220 in 1997 (liquidation value \$9.95 per share)	101	—
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Common stock, par value \$.01 per share, authorized 30,000,000 shares, issued and outstanding 17,459,219 in 1997 and 16,697,988 in 1996	175	167
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Additional paid-in capital	85,513	72,348
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Retained earnings (deficit)	(86,508)	(56,958)
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Cumulative translation adjustment	(139)	(230)
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Total Shareholders' Equity (Deficit)	(772)	15,419
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Total Liabilities and Shareholders' Equity (Deficit)	\$ 37,900	\$ 48,916
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See Notes to Consolidated Financial Statements.

consolidated statements of changes

in shareholders' equity (deficit)

<i>(in thousands)</i>	Preferred Stock Senior Series B	Preferred Stock Senior Series C	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Cumulative Translation Adjustment	Total Shareholders' Equity (Deficit)
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 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
Net income	—	—	—	—	311	—	311
Conversion of Senior Series B Convertible Preferred stock into common stock	(81)	—	11	70	—	—	—
Common stock issued in connection with stock options exercised by employees	—	—	7	2,087	—	—	2,094
Common stock issued in connection with employee stock purchase plan	—	—	1	685	—	—	686
Income tax benefit related to exercise of stock options	—	—	—	30	—	—	30
Common stock issued in connection with warrants exercised	—	—	4	(4)	—	—	—
Common stock issued in connection with acquisition	—	—	2	2,098	—	—	2,100
Equity adjustment for foreign currency translation	—	—	—	—	—	(417)	(417)
Balances at March 31, 1996	92	—	167	72,348	(56,958)	(230)	15,419
Net loss	—	—	—	—	(29,550)	—	(29,550)
Conversion of Senior Series B Convertible Preferred stock into common stock	(6)	—	1	5	—	—	—
Issuance of Preferred Stock Series C	—	101	—	9,289	—	—	9,390
Common stock issued in connection with stock options exercised by employees	—	—	2	447	—	—	449
Common stock issued in connection with employee stock purchase plan	—	—	2	737	—	—	739
Common stock issued in connection with acquisition	—	—	3	2,687	—	—	2,690
Equity adjustment for foreign currency translation	—	—	—	—	—	91	91
Balances at March 31, 1997	\$ 86	\$101	\$175	\$85,513	\$(86,508)	\$(139)	\$ (772)

See Notes to Consolidated Financial Statements.

c o n s o l i d a t e d s t a t e m e n t s o f c a s h f l o w s

(in thousands)

Year ended March 31

1997

1996

1995

Cash Flows from Operating Activities

Net income (loss)	\$(29,550)	\$ 311	\$(48,362)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Write-off of intangible assets	2,288	—	15,185
Restructuring charge	10,942	—	7,109
Gain from settlement of legal dispute	—	(1,230)	—
Depreciation and amortization expense	9,706	7,754	14,176
Loss from disposal of property and equipment	212	11	261
Deferred income taxes	—	—	1,860
Income tax benefit from stock options exercised	—	30	—
Changes in assets and liabilities:			
Decrease in accounts receivable, net	8,126	2,950	13,550
(Increase) decrease in other assets	309	97	(610)
Decrease in accounts payable and accrued expenses	(172)	(1,068)	(3,188)
Increase (decrease) in unearned revenue	(730)	507	439
Decrease in other liabilities	(4,379)	(2,532)	(5,333)
Other, net	410	76	(385)
Net cash provided by (used in) operating activities	(2,838)	6,906	(5,298)

Cash Flows from Investing Activities

Capital expenditures	(1,816)	(1,597)	(4,827)
Capitalized software development costs	(1,113)	(4,138)	(3,831)
Net cash used in investing activities	(2,929)	(5,735)	(8,658)

Cash Flows from Financing Activities

Net proceeds from issuance of preferred stock	9,390	—	—
Net proceeds from issuance of common stock	1,250	2,780	1,831
Property and equipment financing	—	—	682
Repayment of long-term debt and capital leases	(18)	(1,688)	(1,819)

Net cash provided by financing activities	10,622	1,092	694
Effect of exchange-rate changes on cash	(231)	21	339
Net increase (decrease) in cash and cash equivalents	4,624	2,284	(12,923)
Cash and cash equivalents at beginning of year	12,725	10,441	23,364
Cash and cash equivalents at end of year	\$ 17,349	\$12,725	\$ 10,441

See Notes to Consolidated Financial Statements.

Note 1 *Company*

Interleaf, Inc. and its subsidiaries (the Company) develop and market integrated document publishing and management software and services worldwide for networked and Web-based business solutions. The Company's software is used for the electronic assembly, management, retrieval, publishing and distribution of business-critical documents.

Note 2 *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.

Revenue Recognition: Revenue from the license of software products is recognized when the products are shipped, provided there are no significant vendor obligations remaining and collection of the receivable is considered probable. The Company also maintains a reserve for a sales allowance to provide for possible product returns or allowances resulting from a lack of sell through of products by resellers. In the fourth quarter of fiscal 1997, the Company recorded a charge of \$1.5 million to provide for anticipated allowances expected to be granted. Costs associated with insignificant vendor obligations are accrued. Maintenance revenue is recognized ratably over the contract period. Services (consulting and training) revenue is recognized as the related services are performed on either a time and materials basis or pro-rata based on project or contract completion.

Unearned revenue represents the remaining amount of revenue to be recognized in future periods primarily related to maintenance and service contracts.

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. These investments are stated at cost, which approximates market value.

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.

Capitalized Software Development Costs: Costs incurred in the research, design and development of software for sale to others are charged to expense until technological product feasibility is established, after which remaining software development costs are capitalized. These costs are amortized as part of the cost of revenue beginning when the product is available for general release to customers. Such amounts are amortized 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 to the net realizable value of the related 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 4 for discussion of Intangible Asset write-downs recorded during fiscal 1997 and 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 foreign currency transactions are reflected in the statements of operations. The exchange loss for fiscal year 1997 was \$531,000 and not material for fiscal years 1996 and 1995.

Income Taxes: Income taxes have been provided using the liability method in accordance with FASB Statement No. 109, "Accounting for Income Taxes."

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. In February 1997, the Financial Accounting Standards Board issued Statement No. 128, "Earnings Per Share," which is required to be adopted on December 31, 1997. At that time, the Company will be required to change the method currently used to compute earnings per share and to restate all prior periods. Under the new requirements for calculating primary earnings per share, the dilutive effect of stock options will be excluded. The Company has not yet determined what the impact of Statement 128 will be on the calculation of fully diluted earnings per share.

Stock-Based Compensation: Statement of Financial Accounting Standards No. 123 (SFAS 123), "Accounting for Stock-Based Compensation," encourages but does not require companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based employee compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, compensation cost for stock options granted to employees is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock.

Long-Lived Assets: Effective April 1, 1996, the Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," which requires impairment losses to be recorded on long-lived assets used in operations, such as property, equipment and improvements, and intangible assets, when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of the assets. The adoption of this statement did not have an effect on the Company's financial statements.

Concentrations of Credit Risk: Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash investments and accounts receivable. The Company places its cash investments in investment grade instruments with maturities of three months or less and limits the amount of investment with any one financial institution. The credit risk associated with accounts receivable is limited due to the Company's credit evaluation process and the large number of customers and their dispersion over different industries and geographic areas.

Use of Accounting Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include adequacy of restructuring accruals, collectibility of accounts receivable, and recoverability of depreciable assets and intangible assets. Actual results could differ from these estimates.

Basis of Presentation: Certain 1996 and 1995 amounts have been reclassified to conform to the 1997 basis of presentation. The accompanying financial statements have been presented assuming that the Company will continue as a going concern. During 1997, the Company experienced a substantial decline in revenues and a substantial loss from operations, resulting in a shareholders' deficit at March 31, 1997. In response to these matters, the Company developed detailed plans relating to its fiscal 1998 operations which, if realized, will restore the Company to profitable operations. Although no assurances can be given that such plans will be achieved, management is committed to taking all appropriate and necessary actions to effect timely cost reductions in the event that anticipated revenue levels are not achieved. In the event such actions are not successful in achieving

breakeven or profitable operations, additional financing will be needed. Under such circumstances, no assurance can be given that such financing could be obtained or that it could be obtained at commercially reasonable terms or without incurring substantial dilution to existing shareholders. The financial statements do not include any adjustments to reflect the possible effects of these uncertainties. Management believes that, based on the 1998 operating plan and existing cash balances, the Company will have sufficient cash to support operations.

Note 3 Property and Equipment

Property and equipment at March 31 consisted of the following:

<i>(in thousands)</i>	1997	1996
Office, demonstration and other equipment	\$27,739	\$29,142
Development equipment	12,654	13,118
Furniture	3,799	4,296
Leasehold improvements	1,637	1,818
	45,829	48,374
Less allowances for depreciation and amortization	40,866	40,574
	\$ 4,963	\$ 7,800

Note 4 Intangible Assets

The Company's intangible assets have historically been purchased goodwill and capitalized software development costs. The Company's policy has been to amortize purchased goodwill to selling, general and administrative expense and capitalized software development costs to cost of revenue.

In fiscal year 1997, the Company wrote-off goodwill of approximately \$2.3 million related to the acquisition of The Learning Alliance (see Note 13). As a result of a strategic product review, the Company wrote-off capitalized software development costs of \$2.0 million and \$3.2 million in fiscal years 1997 and 1995, respectively. These costs were associated with discontinued products or products with limited future revenue potential. In fiscal year 1995, the Company recorded a charge to write-off goodwill of approximately \$15.2 million which related to the Company's acquisition in prior years of its exclusive distributors in Canada, France and Germany. This goodwill was written-off as the Company had concluded the goodwill was permanently impaired.

The unamortized portion of capitalized software development costs was \$2.3 million and \$6.2 million at March 31, 1997 and 1996, respectively. Amortization and write-downs to net realizable value of capitalized software development costs were approximately \$5.0 million, \$3.2 million, and \$5.3 million during fiscal 1997, 1996 and 1995, respectively.

Note 5 Credit Agreement

The Company has a revolving line of credit up to \$10 million from a major commercial lender. 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 the prime rate plus 2% and are secured by substantially all tangible and intangible domestic assets of the Company. Outstanding letters of credit bear interest at 2%. 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. At March 31, 1997, there were no loans outstanding under this line of credit. Borrowings under the credit agreement are based on the level of eligible North American accounts receivable, modified by cash collections during the previous 90 days. As of March 31, 1997, approximately \$0.8 million of standby letters of credit were outstanding to secure the leasing of computer equipment, and the amount available for additional borrowings is approximately \$1.2 million. The current credit agreement expires in August 1997 and negotiations are underway to establish a new credit facility.

Note 6 *Accrued Expenses*

Accrued expenses at March 31 consisted of the following:

<i>(in thousands)</i>	1997	1996
Accrued compensation and related items	\$ 4,987	\$ 4,790
Taxes, other than income	2,414	2,460
Royalties	1,030	706
Rent	1,228	1,561
Other	4,796	3,738
	\$14,455	\$13,255

Note 7 *Lease Commitments*

The Company leases its headquarters and sales offices, and certain equipment under various operating leases, which expire through the year 2001. Rent expense amounted to approximately \$5.1 million, \$6.6 million, and \$9.4 million during fiscal 1997, 1996, and 1995, respectively.

Future minimum lease commitments on noncancelable operating leases and sublease income are as follows:

<i>(in thousands)</i>	1998	1999	2000	2001	2002	Thereafter
Year Ended March 31						
Future minimum lease commitments on noncancelable leases	\$7,839	\$6,126	\$5,468	\$3,841	\$ —	\$ —
Future minimum sublease income	\$2,285	\$2,058	\$1,974	\$1,403	\$ —	\$ —

These future minimum lease commitments include approximately \$10.3 million, net of sublease income, related to facilities the Company has elected to abandon or downsize in connection with the restructuring and acquisition-related initiatives.

Note 8 *Restructurings*

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.

In the second quarter of fiscal 1997, as a result of a significant decline in product revenue, the Company announced a restructuring plan and recorded a charge of \$4.8 million to reduce employment by approximately 75 people, to close or reduce space in seven sales offices, and to implement the second and final stage of relocating corporate headquarters to smaller and less expensive space. The employee terminations affected all groups throughout the organization. Approximately \$1.3 million of the restructuring charge was for employee termination benefits and \$3.5 million for facility closures and related costs.

In the third quarter of fiscal 1997, the Company announced another restructuring plan and recorded a charge of \$3.7 million to further reduce employment by approximately 100 people at a cost of \$1.8 million and to close or reduce space in six sales offices at a cost of \$1.9 million. The employee terminations affected all groups throughout the organization. In the fourth quarter of fiscal 1997, the Company recorded an additional charge of \$2.4 million to reflect changes in cost and timing assumptions relating to previously restructured facilities.

During the second quarter of fiscal 1995, as part of a Company reorganization and to reduce its size of operations, 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 related 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

notes to consolidated financial statements

continued

\$2.5 million for facility closures and related costs. As a result of the restructuring program, worldwide employment was reduced by approximately 150 people, 19 sales offices were consolidated and a part of headquarters operations was relocated.

The Company paid approximately \$2.7 million, \$0.7 million, and \$4.4 million for employee termination benefits during fiscal 1997, 1996, and 1995, respectively. Payments for facility closures and related costs, net of sublease receipts, were approximately \$1.4 million, \$1.3 million, and \$1.2 million during fiscal 1997, 1996, and 1995, respectively. Expenditures for facility closures, primarily lease payments, are anticipated to continue through the fiscal year 2001.

Note 9 *Income Taxes*

The provision for income taxes is composed of the following:

<i>(in thousands)</i>	1997	1996	1995
Current:			
Federal	\$ —	\$ 30	\$ —
State	—	—	—
Foreign	—	—	258
Total current	—	30	258
Deferred:			
Federal	—	—	1,860
State	—	—	—
Total deferred	—	—	1,860
	\$ —	\$ 30	\$ 2,118

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

<i>(in thousands)</i>	1997	1996	1995
Domestic	\$ (21,586)	\$ 3,793	\$ (43,607)
Foreign	(7,964)	(3,452)	(2,637)
	\$ (29,550)	\$ 341	\$ (46,244)

Total income taxes reported are different from 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:

<i>(in thousands)</i>	1997	1996	1995
Computed at federal statutory rate	\$ (10,047)	\$ 116	\$ (15,723)
Loss for which no tax benefit was realized	9,151	—	9,051
Nondeductible amortization	—	51	397
Nondeductible write-downs	778	—	5,021
Other nondeductible expenses	118	66	101
Benefit of net operating loss carryforward	—	(195)	—
Other temporary differences for which no tax benefit was realized	—	—	1,262
Adjustment to beginning of the year deferred tax asset valuation allowance	—	—	1,860
U.S. and foreign tax rate difference	—	—	123
Other, net	—	(8)	26
	\$ —	\$ 30	\$ 2,118

Deferred taxes result from temporary differences in the recognition of revenues and expenses for tax and financial reporting purposes. The components of the Company's deferred tax assets and liabilities as of March 31 are as follows:

<i>(in thousands)</i>	1997	1996	1995
Deferred tax assets:			
Net operating loss carryforwards	\$ 22,897	\$ 14,919	\$13,453
Tax credit carryforwards	7,150	7,120	6,950
Accrued rent	473	601	738
Reserve for doubtful accounts receivable, vacation and other accruals	864	401	475
Restructuring	2,555	392	888
Total deferred tax assets	33,939	23,433	22,504
Deferred tax asset valuation allowance	(33,619)	(21,294)	(20,594)
	320	2,139	1,910
Deferred tax liabilities:			
Capitalized software development costs	(320)	(1,891)	(1,464)
Depreciation	—	(225)	(422)
Other	—	(23)	(24)
Total deferred tax liabilities	(320)	(2,139)	(1,910)
Net deferred tax asset	\$ —	\$ —	\$ —

Realization of total deferred tax assets is contingent upon future taxable income. A 100% valuation allowance of net deferred tax assets has been established due to the uncertainty of realization of these tax benefits. The deferred tax asset valuation allowance increased \$12.3 million and \$0.7 million during fiscal 1997 and 1996, respectively. 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 not expected to be realized.

At March 31, 1997, the Company and its subsidiaries had net operating loss carryforwards of approximately \$60 million that are available to offset future taxable income. The loss carryforwards are attributable to operations in several tax jurisdictions and expire in 1998 and thereafter. In addition, the Company has research and development and other tax credit carryforwards of approximately \$7 million available to reduce future federal and state income tax liabilities. The tax credit carryforwards expire in 1999 and thereafter. During fiscal 1996, the Company made income tax payments of approximately \$0.3 million. No tax payments were made in 1997 or 1995 (see Note 14).

Note 10 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 can convert each share of preferred stock into 1.34375 shares of common stock. Series B holders converted 61,393, 805,269, and 57,142 shares of Series B Convertible Preferred Stock into shares of the Company's common stock during fiscal 1997, 1996, and 1995, 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.

On October 15, 1996, the Company issued 1,004,904 shares of newly authorized Series C Convertible Preferred Stock ("Series C") at a price of \$9.9512 per share receiving net proceeds of \$9.4 million. In accordance with the agreement, the Company is obligated to issue an additional 1,316 shares of Series C Convertible Preferred Stock. Each Series C share is initially convertible into 4 shares of common stock, which rate is adjustable upon certain issuances of common stock by the Company. Dividends of \$0.24878 per share are payable on April 15, 1998 and October 15, 1998, and \$0.49756 per share on each April 15 and October 15 thereafter. Holders of outstanding shares of Series C Preferred Stock are entitled to the number of votes equal to one-half the number of shares of common stock into which the Series C shares are convertible. Series C shareholders are entitled to receive upon liquidation an amount equal to \$9.9512 per share plus any declared or accrued but unpaid dividends, which amount is payable prior to any payments to holders of the Series B Preferred Stock and common stock. Series C shareholders must convert their shares into common stock upon the consolidation, merger or sale of substantially all assets of the Company or, subject to certain conditions, if the Company's common stock trades for twenty consecutive days above \$3.7317. The Company may, at its option, redeem the Series C shares on or after October 16, 1999. The initial redemption premium is 25%, which decreases 5% annually until October 16, 2004. As part of the Series C issuance, the Company issued warrants to purchase 74,929 shares of common stock at an exercise price of \$2.67 per share to its investment banking firm. These warrants are exercisable until October 15, 2001.

In prior years, the Company had issued warrants to purchase the Company's common stock at various prices in connection with certain research and development agreements and exclusive distribution agreements. The Company issued 366,113 and 72,368 shares of common stock in connection with the exercise of warrants during fiscal 1996 and 1995, respectively. The Company received no proceeds upon the conversion of the warrants into common stock.

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. Options for approximately 2.1 million shares were repriced. 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. At the Annual Meeting of Shareholders on August 17, 1995, shareholders approved an amendment to the Company's 1993 Stock Option Plan to increase the number of shares of common stock available for issuance under the plan by 750,000. In May 1996 and October 1996, the Board of Directors approved amendments to the Company's 1994 Employee Stock Option Plan to increase the number of shares of common stock available for issuance under the plan by 750,000 and 1,000,000, respectively. On September 12, 1996, the Board of Directors authorized a repricing program which allowed employees to elect to reprice all or some of their outstanding options, ranging in exercise price from \$2.75 to \$10.75 per share, to the September 12, 1996 closing price of \$2.5625. Any options repriced were not exercisable until March 12, 1997.

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

<i>(in thousands, except price range of shares)</i>	Number of Shares	Price Range of Shares	Weighted Average Price Per Share
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	—
Granted	798	5.50 - 7.38	6.25
Exercised	(689)	2.75 - 5.75	3.10
Cancelled	(250)	2.75 - 10.63	8.75
Outstanding at March 31, 1996	1,819	2.75 - 10.75	4.50
Granted	2,813	2.05 - 2.56	2.44
Exercised	(154)	2.75 - 4.50	2.90
Cancelled	(1,539)	2.50 - 10.63	5.95
Outstanding at March 31, 1997	2,939	\$2.05 - \$10.75	\$2.75

At March 31, 1997, there were approximately 789,000 shares available for grant. Options exercisable were approximately 1,238,000, 912,000, and 915,000 at March 31, 1997, 1996, and 1995, 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. During fiscal 1997, no options were exercised and in fiscal 1996, 10,000 options were exercised. At March 31, 1997, there were options outstanding to purchase 70,000 shares and 45,000 shares were available for grant. Options exercisable were 70,000, 105,000, and 85,000 at March 31, 1997, 1996, and 1995, respectively.

Pro Forma Disclosure of the Effects of Stock-Based Compensation Plans: The Company accounts for stock-based compensation using the method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123 (SFAS No. 123), "Accounting for Stock-Based

notes to consolidated financial statements

continued

Compensation." Accordingly, no compensation cost has been recognized for the Company's stock option plans and employee stock purchase plan.

Had compensation cost been determined based on the fair value at the grant dates for awards under those plans in fiscal 1997 and 1996 on a basis consistent with the provisions of SFAS No. 123, the Company's net income and earnings per share on a fully diluted basis would have been as indicated below:

<i>(in thousands, except per share amounts)</i>	1997	1996
Net income (loss)—as reported	\$ (29,550)	\$311
Net income (loss)—pro forma	(29,858)	228
Earnings (loss) per share—as reported	(1.70)	0.02
Earnings (loss) per share—pro forma	(1.72)	0.01

Because SFAS No. 123 is only applicable to options granted subsequent to March 31, 1995, its pro forma effects will not be fully reflected until 1998. The fair value of options at date of grant was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

Expected life (years)	4	4
Risk-free interest rate	6.38%	5.79%
Volatility	73.8%	73.8%
Dividend yield	—	—

The weighted-average grant-date fair value of options granted during 1997 and 1996 was \$1.38 and \$2.86, respectively.

The following table summarizes information about stock options outstanding at March 31, 1997:

<i>(in thousands, except price range of shares)</i>	Options Outstanding			Options Exercisable	
	Range of Exercise Prices	Number Outstanding at 3/31/97	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable at 3/31/97
\$2.00 – \$ 2.56	2,591	9.7	\$2.38	1,115	\$2.56
\$2.75 – \$ 5.50	190	6.7	\$2.95	140	\$3.02
\$6.65 – \$ 8.87	225	6.4	\$6.91	89	\$7.28
\$9.00 – \$10.75	3	3.5	\$9.64	3	\$9.64

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 183,000, 157,000, and 208,000 during fiscal 1997, 1996, and 1995, respectively.

At March 31, 1997, approximately 10,235,000 shares of common stock were reserved for issuance primarily related to the Series B and C Convertible Preferred Stock, various stock option plans, warrants, and the Employee Stock Purchase Plan.

Note 11 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 15% 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 fiscal 1995; no contributions were made during fiscal 1997 and 1996.

Note 12 Research and Development Agreement

In October 1988, the Company entered into a joint venture (the Venture) with PruTech Research and Development Partnership III (PruTech), for the purpose of developing and marketing certain products. PruTech contributed approximately \$3.0 million in cash to the Venture; the Company licensed to the Venture certain base technology and was required to perform certain development, marketing and administrative services for the Venture.

In March 1994, PruTech commenced an arbitration action against the Company, alleging, among other things, (i) that the Company had mismanaged the Venture; (ii) that PruTech was entitled to cash distributions of 30% of Venture revenues; and (iii) that certain Venture-owned technology was used in the Company's other products. In November 1995, the Company and PruTech reached an agreement. The Company paid PruTech \$2.1 million (the Purchase Price) in consideration of (i) the acquisition by the Company of PruTech's interest in the Venture, and (ii) the settlement of the pending arbitration action and the release by PruTech of all claims that it may have had against the Company arising out of the formation and operation of the Venture. The Company issued to PruTech 190,000 common stock shares for payment of the Purchase Price. The settlement of the arbitration action resulted in an expense reduction of approximately \$1.2 million, which is included in selling, general and administrative expenses in the Consolidated Statements of Operations. The Venture-owned technology acquired by the Company was valued at \$1.4 million and is included in intangible assets in the Consolidated Balance Sheets. The technology is being amortized in the same manner as other capitalized software development costs.

Note 13 Acquisitions

On May 1, 1996, the Company purchased all of the outstanding equity securities of The Learning Alliance, Inc. ("TLA") for 341,500 shares of common stock valued at approximately \$2.7 million. TLA provides sales training services and develops and markets related software for the sales force automation and integration marketplace.

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 estimated fair values. The acquisition resulted in goodwill of approximately \$2.6 million.

In December 1996, in order to allow the Company's management to focus on development of its core businesses, the Company decided to divest itself of TLA. TLA was sold in January 1997 for future royalty considerations and foregone severance payments. As a result of this decision, in December 1996 the Company recorded a write-down of approximately \$2.3 million of goodwill which had been recorded in connection with the acquisition.

The operating results of TLA, which were not material, have been included in the consolidated financial statements from the date of the acquisition to the date of disposition. Pro forma presentations have not been included as the acquisition was not material to the results of operations of the Company.

Note 14 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.

Interleaf's German subsidiary, Interleaf GmbH, has been notified that it is liable for certain German withholding taxes related to payments remitted to the United States from Germany. The Company is appealing this assessment; however, approximately \$1.1 million of the cash and cash equivalents balance at March 31, 1997 and 1996 has been restricted for potential payment of the German withholding taxes. The Company believes the final outcome will not have a material adverse effect on the financial position or results of operations of the Company.

n o t e s t o c o n s o l i d a t e d f i n a n c i a l s t a t e m e n t s

c o n t i n u e d

Note 15 Industry Segment and Geographic Information

The Company operates in a single industry segment: developing and marketing integrated document publishing software and services worldwide.

Information regarding geographic areas at March 31, 1997, 1996 and 1995, and for the years then ended is as follows:

(in thousands)

March 31, 1997

and for the year then ended

	U.S.	Non-U.S.	Eliminations	Total
Sales to unaffiliated customers	\$ 39,558	\$ 25,265	\$ —	\$ 64,823
Intercompany royalties and transfers	6,547	201	(6,748)	—
Net revenues	46,105	25,466	(6,748)	64,823
Income (loss) from operations	(21,025)	(7,594)	—	(28,619)
Identifiable assets	58,575	19,288	(39,963)	37,900

March 31, 1996

and for the year then ended

	U.S.	Non-U.S.	Eliminations	Total
Sales to unaffiliated customers	\$ 54,953	\$ 33,604	\$ —	\$ 88,557
Intercompany royalties and transfers	8,770	—	(8,770)	—
Net revenues	63,723	33,604	(8,770)	88,557
Income (loss) from operations	2,797	(2,764)	83	116
Identifiable assets	63,734	17,590	(32,408)	48,916

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

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. as of March 31, 1997 and 1996, and the related consolidated statements of operations, changes in shareholders' equity (deficit), and cash flows for each of the three years in the period ended March 31, 1997. 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Interleaf, Inc. at March 31, 1997 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended March 31, 1997, in conformity with generally accepted accounting principles.

Ernst + Young LLP

Boston, Massachusetts
June 16, 1997

s u p p l e m e n t a l f i n a n c i a l i n f o r m a t i o n

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1997 and 1996 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 1997					
Revenues	\$19,054	\$ 16,585	\$15,348	\$13,836 ^d	\$ 64,823
Gross margin	11,920	9,405	8,842	6,552	36,719
Net income (loss)	(3,800)	(10,327) ^a	(9,509) ^{a, b}	(5,914) ^{a, e}	(29,550)
Net income (loss) per share	(0.22)	(0.59)	(0.54)	(0.35)	(1.70)
Common stock prices					
High	8%	5%	3%	2 ⁷ / ₁₆	8%
Low	6 ¹ / ₂	2%	1%	1%	1%
Close	6 ¹ / ₂	2%	1%	1 ¹ / ₁₆	1 ¹ / ₁₆
Fiscal 1996					
Revenues	\$23,127	\$ 23,311	\$21,255	\$20,864	\$ 88,557
Gross margin	15,289	15,666	13,883	13,827	58,665
Net income (loss)	472	922	429 ^c	(1,512)	311
Net income (loss) per share	0.03	0.05	0.02	(0.09)	0.02
Common stock prices					
High	8	11	12%	10%	12%
Low	4 ¹ / ₂	7 ¹ / ₂	7 ¹ / ₂	6%	4%
Close	7 ¹ / ₂	10	10%	8%	8%

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

The Company's common stock is traded on the over-the-counter market and is quoted on the NASDAQ National Market tier of the NASDAQ Stock Market under the symbol LEAF. On June 18, 1997, there were 839 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.

Notes to Supplemental Financial Information

- a. Includes restructuring charges of \$4.8 million, \$3.7 million, and \$2.4 million for the second, third, and fourth quarter, respectively. These restructuring charges were to reduce worldwide employment and facility costs.
- b. Includes a \$2.3 million write-off of goodwill related to the TLA acquisition.
- c. Includes a \$1.2 million benefit from the settlement of a long-term dispute with a joint venture partner.
- d. Includes a \$1.5 million reserve for sales allowances.
- e. Includes a \$2.2 million write-off of capitalized software development costs, inventory, and prepaid royalties for discontinued products and products with limited future revenue potential.

Interleaf Management

from left to right:

Robert R. Langer

Vice President, Finance and Administration
and Chief Financial Officer

Michael L. Torto

Vice President, Marketing

D. Wayne Peters

Vice President and Corporate Controller

Carolyn Hills

Acting Vice President, Consulting

Jaime W. Ellertson

President and Chief Executive Officer

Gary R. Phillips

Vice President, North American Sales

Robert A. Fisher

Vice President, Customer Support

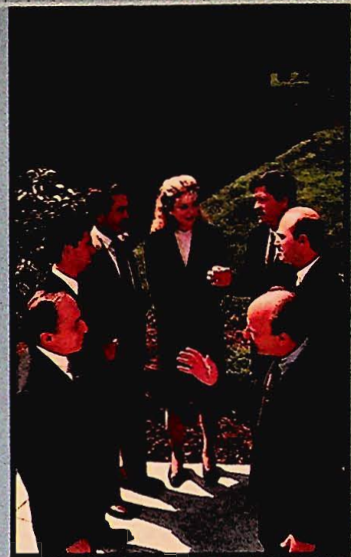
Not pictured:

Christopher McKee

Vice President, Europe, Middle East, Africa

Tom Lovegrove

Vice President, Telesales and Channels



c o r p o r a t e i n f o r m a t i o n

Corporate Officers

Jaime W. Ellertson

President and Chief Executive Officer

Robert A. Fisher

Vice President, Customer Support

Robert R. Langer

Vice President, Finance and
Administration and
Chief Financial Officer

Christopher McKee

Vice President, Europe,
Middle East and Africa

Gary R. Phillips

Vice President, Sales

Michael L. Torto

Vice President, Marketing

Board of Directors

Frederick B. Bamber

General Partner
Applied Technology Partners, L.P.

David A. Boucher

General Partner
Applied Technology Partners, L.P.

Rory J. Cowari

Chairman of the Board
Interleaf, Inc. and President
and Chief Executive Officer
LIONBRIDGE Technologies, Inc.

Jaime W. Ellertson

President and Chief Executive Officer
Interleaf, Inc.

Marcia J. Hooper

Vice President
Advent International Corporation

George D. Potter, Jr.

President
Quality Systems International

Shareholder Information

Common Stock

Interleaf's common stock is traded
over the counter on the NASDAQ
National Market tier of the NASDAQ
Stock Market™—symbol LEAF

Annual Meeting

The Annual Meeting of Shareholders
will be held on August 15, 1997
at 8:30 a.m. at Interleaf, Inc.,
62 Fourth 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.
62 Fourth Avenue
Waltham, MA 02154

Transfer Agent

BankBoston, N.A.
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:
BankBoston, N.A.
c/o Boston EquiServe, L.P.
PO Box 644
Mail Stop: #5-02-64
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.
62 Fourth Avenue
Waltham, MA 02154
USA

Field Offices:

North America

El Segundo, Redwood Shores,
California; Boulder, Colorado;
Greenbelt, Maryland; Waltham,
Massachusetts; Dallas, Texas;
Ottawa, Ontario

International

Sydney, Australia; Brussels, Belgium;
Paris, France; Frankfurt, Germany;
Milan, Italy; Tokyo, Japan; London, U.K.

Interleaf Worldwide

Locations

Interleaf, Inc.

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USA
617-290-0710

Interleaf Australia

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200 Pacific Highway
Crows Nest
New South Wales
2065 Australia
61-2-9956-5433

Interleaf Japan

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Building 10-F
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Persimmon House
Brooklands Business Park
Weybridge
Surrey KT13 0YP
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Interleaf