

Interleaf

*Leading the
way in content
management*

Interleaf

Annual Report 1998

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T OCKHOLDERS

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ACCOMPLISHMENTS
& STRATEGY

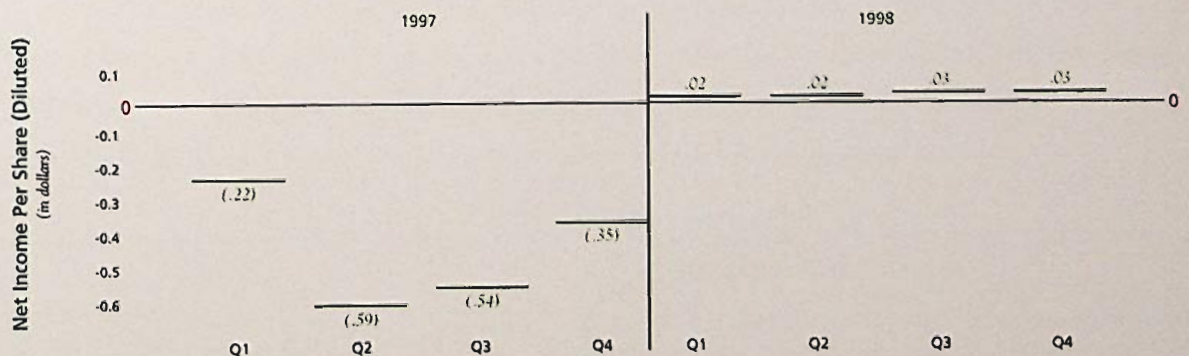
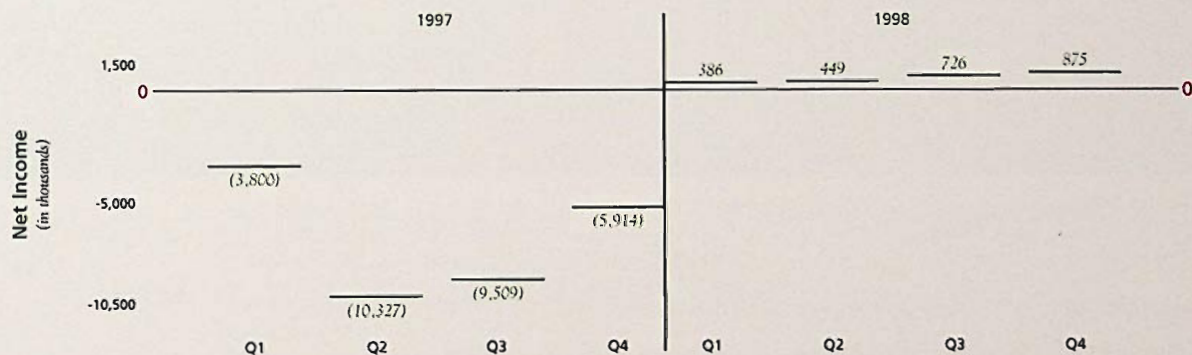
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CORPORATE
INFORMATION

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FINANCIAL
REVIEW

Interleaf. The Enterprise Content Management Experts. At Interleaf, we help companies around the world profit and prosper from the power of their information resources. Over two-thirds of Global 1000 companies rely on Interleaf software solutions to create, assemble and distribute business-critical information. And now, with our proven industry experience, we're enabling companies to harness the power of converging technologies including the Web and new open standards in a rapidly emerging market called content management. With our unique content management solutions for corporate enterprises, called Enterprise Content Management (ECM), we intend to drive our customers' success—and our own growth.



➤ **1998** marked a critical turning point in Interleaf's transformation process. With new management and a new direction, we achieved our goal of returning to profitability while building a stable platform for future growth.

We successfully turned 1997's \$29.6 million loss into a \$2.4 million profit in 1998. During the year, quarterly revenue increased from \$12.8 million to \$13.4 million. We also boosted profitability every quarter, and reduced staff turnover to below the industry average.

In short, we accomplished our 1998 goals. But this is just the first stage of a multi-part process to return Interleaf to growth. Our second, and perhaps greatest challenge, is to grow revenue while we expand our customer base.

To that end, we are focusing our efforts on implementing a new, aggressive growth strategy. We spent a good portion of the year analyzing our customer base, conducting extensive market research, and meeting firsthand with customers and prospects. The result is a plan which intelligently addresses the needs of our current customer base and leverages our core competencies in new, rapidly growing markets.

Our new strategy focuses on two core markets. The first is complex publishing. Interleaf remains a leader in providing complex document publishing solutions with our proven Interleaf 6 product family. This market currently provides a majority of our revenue. In addition, the upcoming release of Interleaf 7 holds strong promise for increased sales in this market during fiscal 1999.

“With new management and a new
D I R E C T I O N, we achieved our goal of
returning to profitability while building a stable
platform for future **G R O W T H**.”



The second market is the key component of our strategy for future growth. It's a rapidly growing area where we can leverage our current technology strengths and customer base to become a dominant player—a market that takes advantage of the explosive growth of the Web while enabling us to provide our customers with business solutions that directly enhance their profitability. This market for improving the way companies utilize information is called "content management." According to CAP Ventures, an independent research and consulting firm, the \$500 million intranet content management market is expected to grow at 100% a year. That's four times the growth of the document management market and ten times the growth of technical document publishing.

As we implement our new content management strategy for the enterprise, we are focusing our initial efforts on two of the largest customer groups in our worldwide installed base—manufacturing and finance. As part of our new product line, in March we announced the first Enterprise Content Management (ECM) system based on the emerging XML standard, code-named "BladeRunner."

With a new corporate direction, a new market focus, and a new ECM solution strategy, we're ready to take advantage of growing markets and new opportunities. In addition, we will offer all of our products not only as technology solutions, but as comprehensive out-sourced solutions as well.

You'll learn more about our strategic plans and prospects on the pages that follow. Of course, our success is ultimately measured by our ability to deliver greater shareholder value. Our average stock price for the first quarter of last year versus the first quarter of this year as of mid-June increased over 100%. While we have made significant progress to date, we look forward to greater success ahead and appreciate your continued support.

Sincerely,

A handwritten signature in black ink, appearing to read "Jaime W. Ellertson". The signature is stylized with a large, looping initial "J" and "E".

JAIME W. ELLERTSON – PRESIDENT AND CHIEF EXECUTIVE OFFICER

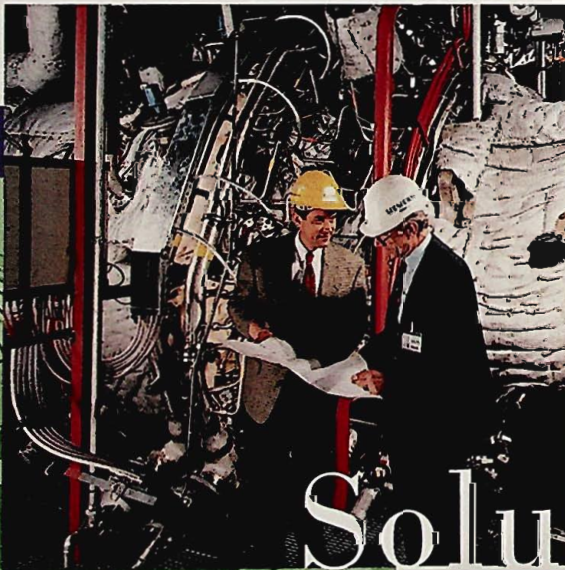
DIGITAL SOLUTIONS FOR A DIGITAL WORLD. With the dramatic growth of corporate intranets as the basic internal communications vehicle for companies around the world, the opportunities for Interleaf have grown as well.

For the first time, corporate intranets have created a network infrastructure that's common among internal as well as external corporate users. This digital backbone environment requires new digital communication solutions—especially when it comes to utilizing a company's valuable information assets, which may range from normal text and graphics, all the way to audio and video.

However, creating, distributing and displaying corporate information on the Web is quite different from doing it on paper. And that's where Interleaf's proven expertise in creating, distributing and managing key corporate information gives us an advantage.

DRAWING ON OUR UNIQUE STRENGTHS. Interleaf's 15 years of complex authoring, publishing and document management expertise, consulting experience and blue chip customer base present us with a powerful opportunity. By leveraging our key assets and experience, we're well positioned to take advantage of this digital revolution as we bring our experience with electronic content to the Web and corporate intranets. Our new strategy leverages the rapidly growing market called "content management"—a market driven by XML, an emerging open standard.

LEVERAGING THE CONTENT MANAGEMENT MARKET. Simply stated, content management is the ability to manage documents at a component or element level by adding structure and intelligence. Our version of content management for corporate enterprises is called Enterprise Content Management or ECM.



“XML-based solutions will enable Siemens to extend what we've accomplished with SGML in order to further improve information sharing with our suppliers and our customers. The end result will be

improvements in the consistency, quality, completeness, and maintainability of our power plants.”

MICHAEL ECKERT – VICE PRESIDENT, ENGINEERING
Siemens Power Corporation

http://

Innovation

Distributing our Corporate Policies and Procedures manual over a global corporate intranet benefits StorageTek

by drastically reducing distribution time from 3-7 weeks to 1-2 days. Of equal importance, StorageTek can now guarantee that the latest documents that meet user, legal and ISO requirements are in the hands of the reader without the inconvenience and cost associated with updating and redistributing paper copies worldwide.”

WILEY R. ANDERSON – Corporate Vice President
Worldwide Sourcing/Logistics/Systems
Storage Technology Corporation

With ECM, information components will be re-used as building blocks to generate new types of virtual, electronic documents as needed. Enterprise Content Management will enable information to be re-purposed more effectively so a document can be created once and then re-used many times in different forms.

For example, one of our new ECM solutions enables manufacturers to automatically store their product documentation from Microsoft® Word in a repository where it can be simultaneously utilized in documents such as training manuals and pre-sale Web sites. These customized just-in-time documents can then serve as an interface into customer order entry systems so the users of these documents can easily order replacement parts and supplies. So we're actually integrating electronic documentation into the business environment that drives commerce, customer service and other corporate functions—to help companies get more value from their information assets.

BUILDING ON THE NEW XML STANDARD. Because Enterprise Content Management must work for the Web and corporate intranets, it requires a digital format—and that's the emerging open standard XML or “eXtensible Markup Language.”

XML is the fast-growing enabling technology that's more functional than HTML (Hyper Text Markup Language), yet less costly and complicated than SGML (Standard Generalized Markup Language). Interleaf's XML-based products will be able to deliver the functional benefits of SGML without the complexities or expense previously required.



Technology

“With the Interleaf system our people spend more quality time in front of the customers and less time searching for the right information.”

PETER GREENFIELD – MANAGER, BUSINESS COMMUNICATIONS
Abbey National plc

“We wanted to give branches the necessary tools so they could work with customers not only reactively but proactively. It is very important to be able to approach the customer at the right moment.”

PATRICK TOEBACK – PROJECT LEADER
CERA Bank

“The Interleaf system improves customer satisfaction by allowing access to information more efficiently and rapidly, thereby helping to retain Halifax’s existing customers and attracting new investors.”

JOHN BROWN – MANAGER, DISTRIBUTION OPERATIONS PLANNING
Halifax plc

XML is the basic format in which Interleaf stores the document components, or elements, as well as the document structure. It works much like a universal file system that tags and categorizes information for automated assembly to make it more accessible and valuable. In other words, it provides the intelligence behind content management. With support from all the major vendors including Microsoft, Oracle, Netscape and Sun, we believe XML will be widely adopted by corporations around the world. Therefore, XML is an important part of our strategy moving forward—both for new and existing products.

TARGETING OUR OPPORTUNITIES FOR GROWTH. In addition to leveraging the growing content management market and XML standard, our strategy for growth and profitability begins with our greatest and most immediate opportunity—our own customer base of the world’s top companies including leading manufacturers and financial service providers.

While our installed base is already familiar with Interleaf products in the enterprise publishing market, our opportunity lies in the fact that many of these customers are just beginning to utilize their corporate intranets to drive their businesses. We’re about to change all that.

DRIVING CUSTOMER PROFITS. At Interleaf, we’re helping corporations turn to the power of their own corporate information to improve customer satisfaction, and increase revenue and profits. And our long-standing role in enterprise publishing provides us with a valuable strategic advantage. Where enterprise publishing was once seen as part of the cost of doing business, organizations are now looking to document-enabled

and content-enabled applications from a broader perspective—to literally help drive their business and improve the bottom line.

SUPERIOR SOFTWARE SOLUTIONS. Our new strategy is already taking shape. In March of this year, Interleaf announced the industry's first XML-based Enterprise Content Management solution, code-named "BladeRunner." Targeted for shipment in the fourth quarter of calendar year 1998, BladeRunner will deliver the power of XML to everyone's desktop. The result will dramatically increase information reuse, improve information searching and retrieval, and provide the expanded ability to publish to multiple outputs such as the Web, CD's or paper—all from one set of content.

BladeRunner will build on our Web solutions introduced last year, the Interleaf Xtreme (IXtreme) product family. IXtreme products enable users to easily publish to the corporate intranet or extranet. Unlike traditional solutions, there's no labor-intensive document conversion to HTML needed and no training or special skills required. It's the fastest and easiest way to Web-enable documents and maximize an organization's information assets.

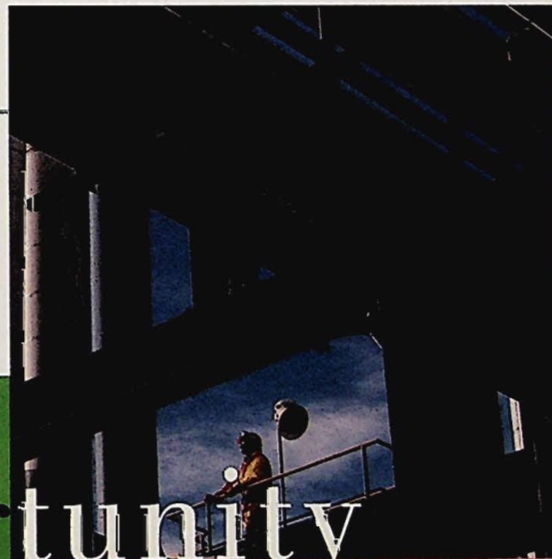
STRENGTHENING OUR CUSTOMER COMMITMENT. While leading the way with innovative product solutions, we are also committed to protecting our customers' investment in Interleaf products and bringing new features and functionality to our installed base.

Accordingly, a new version of our powerful workgroup publishing solution, Interleaf 7, is planned for 1998. It will offer improved features that make it even easier to create complex documents, share information and manage projects. Of course, Interleaf 7 will be Year 2000 compliant, and we will also continue to fully support customers who utilize Interleaf 6 and Interleaf 5 with Year 2000 compliant versions of each.

“Continuing engineering improvements, special customer requests, shortened manufacturing cycles and engineering changes from suppliers keep Fisher-Rosemount in a dynamic environment. The PROVOX® and RS3™ Interleaf-based DOCVUE™ electronic documentation systems enable us to provide frequent and accurate

Opportunity
revisions to our technical documentation that are easy for customers to use and understand. The DOCVUE system is a key in providing value to our customers.”

JAMES R. NORWOOD – VICE PRESIDENT, QUALITY & CUSTOMER SATISFACTION
Fisher-Rosemount Systems, Inc.



In 1998, we also plan to introduce new versions of many applications that complement Interleaf publishing workgroup applications. For example, our BusinessWeb™ Plus solution provides ready access to corporate information through standard Web browser technology. Additionally, we expect to release a new version of our RDM™ Document Management System in 1998.

SUPPORT AT EVERY TURN. Many companies promise excellent customer support, but at Interleaf we actually deliver it with one of the largest, most comprehensive groups of consulting, service and support professionals in the enterprise publishing and content management marketplace. The Interleaf Professional Services Group (IPSG) backs every product we offer with in-depth technical and industry expertise. Our service expertise also enables us to offer our technology as a complete out-sourced solution to ensure our customers' success in managing costs and meeting their core business objectives. In addition, our worldwide education centers provide all the training needed to help our customers maximize the value of our products.

A NEW BEGINNING. The opportunity is before us. The rapidly growing digital world presents businesses with a practical, cost-effective way to gain strategic value from accurate, appropriate and timely information. And increasingly, companies around the globe are turning to the power of their corporate intranets and the Web to achieve their business goals.

At Interleaf, we're providing a better digital solution to help companies drive their revenues. Our goal is to achieve dominance in the rapidly growing content management market by leveraging our own depth of experience and the emerging XML standard. And, by targeting our markets with innovative software solutions, we're well poised for growth.



Performance

“The Interleaf system enables Morningstar to effectively develop and distribute customized, time-sensitive financial reports that represent the

essence of our exacting data and graphical standards.”

JOE SUTTON – CHIEF FINANCIAL OFFICER
Morningstar

f i n a n c i a l

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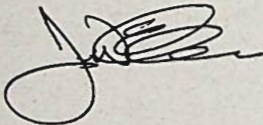
REPORT OF MANAGEMENT

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 judgement and incorporate accounting policies that are reasonable and prudent for the Company's business environment. The financial statements have been audited by our independent public accountants, Ernst & Young LLP, and their report is included elsewhere herein.

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

The Board of Directors carries out its responsibility for these financial statements through its Audit Committee, composed of non-employee Directors. The Audit Committee reviews the financial statements before they are released for publication. The Audit 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



Peter J. Rice
Vice President, Finance and Administration
and Chief Financial Officer

SELECTED FIVE-YEAR FINANCIAL DATA

(In thousands except per share amounts)

Year ended March 31	1998	1997 ^a	1996 ^b	1995 ^c	1994 ^d
Total revenues	\$52,577	\$ 64,823	\$88,557	\$ 87,856	\$111,229
Net income (loss)	2,436	(29,550)	311	(48,362)	(8,448)
Net income (loss) applicable to common shareholders	1,978	(29,550)	311	(48,362)	(8,448)
Net income (loss) per share:					
Basic	\$ 0.11	\$ (1.70)	\$ 0.02	\$ (3.47)	\$ (0.63)
Diluted	\$ 0.09	\$ (1.70)	\$ 0.02	\$ (3.47)	\$ (0.63)
Shares used in computing net income (loss) per share:					
Basic	17,857	17,344	15,557	13,938	13,384
Diluted	24,808	17,344	18,495	13,938	13,384
Total assets	\$39,388	\$ 37,900	\$48,916	\$ 50,793	\$ 96,884
Long-term obligations	2,063	2,955	773	625	1,565
Total shareholders' equity (deficit)	\$ 9,310	\$ (772)	\$15,419	\$ 10,615	\$ 56,632
Common shares outstanding	18,155	17,459	16,698	14,203	13,631

^a Fiscal 1997 results include \$10.9 million of restructuring charge 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 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 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

The information provided in this Annual Report contains forward-looking information. The Company's actual future results may differ materially from the projections or suggestions made in such forward-looking information and may fluctuate between operating periods. Certain factors that might cause such differences and fluctuations include the factors discussed below under "Risk Factors."

Results of Operations

Overview: The Company reported net income of \$2.4 million on total revenues of \$52.6 million in fiscal 1998. This compares with a net loss of \$29.6 million on revenues of \$64.8 million, and net income of \$0.3 million on revenues of \$88.6 million in fiscal 1997 and 1996, respectively. Much of the decline in total revenue during the periods is due to a decrease in product revenue, and the related impact on maintenance and service revenue caused by the ongoing maturation of the market for complex authoring products and the increasing popularity of low-end versions of Windows-based authoring software. The Company has continued its efforts in fiscal 1998 to focus on developing and supporting a new family of publishing products (Xtreme) based on Internet technologies, targeted toward its customers' extended enterprise. The return to profitability in fiscal 1998 was primarily due to the impact of significant reductions to the cost structure of the Company during the second, third and fourth quarters of fiscal 1997. During these three quarters of fiscal 1997, headcount was reduced, facilities were closed or downsized, and various cost control measures were implemented.

In early 1998, Interleaf entered the content management marketplace, an emerging market centered around the disassembly and re-purposing of information at a reusable unit level, and improving information sharing through the Internet and corporate intranets. The Company intends to introduce content management products in this market during fiscal 1999.

REVENUES

Product: In the fiscal years ended March 31, 1998, 1997 and 1996, worldwide product revenues were \$13.3 million, \$18.8 million and \$34.8 million, respectively, representing 25%, 29% and 39%, respectively, of the Company's total revenues. There was a decrease in total product revenue of \$5.5 million (29%) in fiscal 1998 from fiscal 1997 and a decrease of \$16.0 million (46%) in fiscal 1997 from fiscal 1996. Revenue declined in all geographic regions. The continued decline in product license revenue was due to the following factors. The first factor was the increasing popularity of Windows-based publishing software. Second, there was considerable consolidation in the aerospace/defense industry, where the Company had historically derived most of its authoring product license revenue. In addition, this industry became saturated with high-end authoring software.

The Company is refocusing its business strategy on providing a new family of content management products targeted toward specific vertical markets. While the Company has built well-accepted integrated document publishing solutions for individual customers, it has not yet demonstrated the ability to develop, market and sell content management products. There is no assurance that the Company will be successful in implementing this strategy. Therefore, the Company is unable to predict if or when product revenues will stabilize or grow. Additionally, since the Company's services and maintenance revenues are largely dependent on new product licenses, these revenue components have also experienced downward pressure, which may continue.

Maintenance: In the fiscal years ended March 31, 1998, 1997 and 1996, worldwide maintenance revenues were \$26.1 million, \$29.0 million and \$32.3 million, respectively, representing 50%, 45% and 36%, respectively, of the Company's total revenues. There was a decrease in total maintenance revenue of \$2.9 million (10%) in fiscal 1998 from fiscal 1997, and a decrease of \$3.3 million (10%) in fiscal 1997 from fiscal 1996. Revenue declined in all geographic regions. Future maintenance revenue is dependent on the Company's ability to maintain its existing customer base, to release new versions of its traditional products, and to increase maintenance contract volume related to the new content management products.

Services: Services revenue consists of revenue from consulting and customer training. During the fiscal years ended March 31, 1998, 1997 and 1996, worldwide revenues from services were approximately \$13.2 million, \$17.0 million and \$21.5 million, respectively, representing approximately 25%, 26% and 24%, respectively, of the Company's total revenues. There was a decrease in services revenue of \$3.8 million (23%) in fiscal 1998 from fiscal 1997, and a decrease of \$4.5 million (21%) in fiscal 1997 from fiscal 1996. Service revenue declined in all geographic regions. Future services revenue is dependent on the Company's ability to maintain its existing customer base and to increase consulting and training contracts based on the successful introduction of new products.

North America: Revenues in North America were approximately \$36.3 million (69%), \$41.8 million (64%) and \$57.1 million (64%) of total revenues during fiscal 1998, 1997 and 1996, respectively. The decline in fiscal 1998 was primarily due to a decrease in product license and maintenance revenues. The decline in fiscal 1997 was primarily due to a decrease in product license and consulting revenues.

International: Revenues from the Company's international operations were approximately \$16.3 million (31%), \$23.0 million (36%) and \$31.5 million (36%) during fiscal 1998, 1997 and 1996, respectively. The declines in fiscal 1998 and fiscal 1997 were primarily due to lower product revenue compared to the prior fiscal years.

Fiscal 1999: During fiscal 1999, the Company plans to develop and release several upgrades to its traditional products. The Company also plans to develop product offerings which address at least two vertical segments of the content management market. Growth in revenues during fiscal 1999 and fiscal 2000 will be largely dependent on the introduction and customer acceptance of the new and enhanced software products planned to be released in fiscal 1999 and the following year, and the Company's success in leveraging software products with services to provide web-based content management solutions to its customers, improving sales force productivity and the effectiveness of the Company's investment in marketing and lead generation programs. If the Company is unable to grow or stabilize its revenues in fiscal 1999, further expense reductions will be necessary in order to sustain operations.

COSTS OF REVENUES

Cost of product revenues includes amortization of capitalized software development costs, product media, documentation materials, packaging and shipping costs, and royalties paid for licensed technology. In the fiscal years ended March 31, 1998, 1997 and 1996, worldwide cost of product revenues were \$4.0 million, \$7.5 million and \$6.4 million, respectively, representing 30%, 40% and 18%, respectively, of the Company's total product revenues. Total cost of product revenue decreased by \$3.5 million (47%) in fiscal 1998 from fiscal 1997, and there was an increase of \$1.1 million (17%) in fiscal 1997 from fiscal 1996. The increase in costs of product revenues from fiscal 1996 to fiscal 1997, and the decline the following year is due to a write-off of capitalized software development costs that occurred in fiscal 1997, and the lower annual amortization that resulted in fiscal 1998. This write-off was related to the Company's fiscal 1997 restructuring.

In the fiscal years ended March 31, 1998, 1997 and 1996, worldwide cost of maintenance revenues were \$3.7 million, \$4.6 million and \$5.2 million, respectively, representing 14%, 16% and 16%, respectively, of the Company's total maintenance revenues. Total cost of maintenance revenue decreased by \$.9 million (20%) in fiscal 1998 from fiscal 1997, and by \$.6 million (12%) in fiscal 1997 from fiscal 1996. The major reason for the decreases was a reduction in customer support personnel associated with the fiscal year 1995 and 1997 restructuring.

In the fiscal years ended March 31, 1998, 1997 and 1996, worldwide cost of services revenue were \$11.3 million, \$16.0 million and \$18.3 million, respectively, representing 86%, 94% and 85%, respectively, of the Company's total services revenue. Total cost of services revenue decreased by \$4.7 million (29%) in fiscal 1998 from fiscal 1997, and by \$2.3 million (13%) in fiscal 1997 from fiscal 1996. The decreases in both fiscal 1998 and fiscal 1997 from fiscal 1996 were related to the decline in product and services revenues, and the fiscal year 1997 restructuring.

OPERATING EXPENSES

Selling, General and Administrative ("SG&A"): SG&A expenses decreased by \$14.8 million (40%) in fiscal 1998 from fiscal 1997, and by \$5.6 million (13%) in fiscal 1997 from fiscal 1996. The decline was primarily due to significant personnel and facilities expense reductions related to the Company's fiscal 1995 and 1997 restructurings.

Research and Development ("R&D"): R&D expenses consist primarily of personnel expenses to support product development net of capitalized software development costs. During the fiscal years ended March 31, 1998, 1997 and 1996, the Company's product development and engineering expenses, including the amortization of software development costs, were approximately \$10.6 million, \$20.0 million and \$19.1 million, respectively, representing 20%, 31% and 22%, respectively, of the Company's total revenues. R&D expenses decreased by \$6.1 million (41%) in fiscal 1998 from fiscal 1997, and by \$0.9 million (6%) in fiscal 1997 from 1996. There were no software development costs capitalized in fiscal 1998.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS

(continued)

INCOME TAXES

In fiscal 1998, an alternative minimum tax provision was provided. 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.

The Company has net operating loss carryforwards of approximately \$63 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 \$21.1 million of cash and cash equivalents at March 31, 1998, an increase of approximately \$3.8 million from March 31, 1997. The net increase was the result of \$6.8 million in cash received from the private placement described below and in Note 10 to the Consolidated Financial Statements, partially offset by \$3.1 million in restructuring payments as described in Note 8 to the Consolidated Financial Statements. At March 31, 1998 and March 31, 1997, the Company had approximately \$1.1 million of cash restricted for potential payment of a withholding tax assessment on its German subsidiary related to payments remitted to the United States from Germany in 1990. The Company is appealing this assessment.

On September 30, 1997, the Company completed a private placement resulting in net proceeds to the Company of \$6.8 million from the issuance of 7,625 shares of 6% Convertible Preferred Stock and placement agent warrants to purchase 763 additional shares of 6% Convertible Preferred Stock. See Risk Factors and Note 10 to the Consolidated Financial Statements.

For the year ended March 31, 1998, the Company paid approximately \$3.1 million, net of sublease receipts, related to the fiscal 1997 and 1995 restructurings, compared to \$4.9 million paid during the same period in fiscal 1997. 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.

In August 1997, the Company's revolving line of credit and \$0.7 million equipment letter of credit with a major commercial lender expired. This revolving line of credit was never utilized in either fiscal 1997 or 1998, but any borrowed amounts would have been secured by substantially all domestic assets of the Company. At March 31, 1998, the Company has obtained from another major commercial lender a new equipment letter of credit for \$0.6 million, which is secured by the equivalent amount of cash.

During fiscal year 1997, the Company experienced a substantial decline in revenues and a substantial loss from operations which resulted in a shareholders' deficit at March 31, 1997. In response to the downward trend in revenues, management took appropriate expense control actions relating to operations, which restored the Company to profitability through fiscal 1998. While the Company showed a modest profit in fiscal 1998, no assurances can be given that profitable operations can be sustained. 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.

The Company believes its current cash balances and cash generated from operations, offset by restructuring payments, will be sufficient to meet the Company's liquidity needs for fiscal 1999.

The Company has undertaken a comprehensive evaluation of its internal information systems in order to evaluate those modifications which will be required in order to address Year 2000 functionality and other operational deficiencies. This review is substantially complete, and the Company has estimated that the cost or risk which may be associated with its Year 2000 or other internal operational issues is not material. The Company expects to upgrade certain hardware and software during the next fiscal year in order to become compliant. The estimated cost of these upgrades is less than \$.5 million.

Risk Factors

The following risk factors should be carefully considered in evaluating the Company and its business.

The Company has experienced a decline in revenue over recent years, due to the decrease in product, maintenance and service revenue caused by maturation of the market for its traditional publishing products, and the increased popularity of low cost versions of competitive Windows-based software. Unless the Company develops new products and markets, revenues could be expected to continue to decline.

The Company's growth will depend, in significant part, on the development, introduction and customer acceptance of new and enhanced products, particularly content management products. New markets such as content management are characterized by evolving industry standards, rapid technological change and unknown and changing customer requirements. The content management market is just beginning to emerge, is intensely competitive, highly fragmented and subject to rapid change. There can be no assurance that the content management market will coalesce and continue to grow, that the Company will successfully develop content management software or that such software will be accepted in the marketplace.

Future results will depend upon many factors, including the demand for the Company's existing products, the ability of the Company to develop and market new products, market acceptance of the Company's new products, the timing of new product introductions and product enhancements by the Company and its competitors, the level of product and price competition, the length of the Company's sales cycle, the size and timing of individual license transactions, the delay or deferral of customer implementation of new software and services, the budget cycles of the Company's customers, the mix of products and services sold, activities of competitors, changes in foreign currency exchange rates, and general domestic and international economic and political conditions.

The Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance.

The market for the Company's existing technical documentation products is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. Several competitors have greater market penetration and acceptance, significantly greater financial, technical, marketing and other resources, significantly greater name recognition and a larger installed base of customers than the Company.

The Company is seeking to establish strategic relationships with companies with outsourcing or service bureau businesses, and with companies that have presence and publishing expertise in the financial services market. The Company has relationships with various technology providers, which are important to the Company's entrance into the content management market. The failure of the Company to establish and/or maintain these relationships, or to establish additional future relationships would have a material adverse effect on the Company.

The Company is investigating the possibility of making acquisitions of, or significant investments in, businesses that offer complementary products and technologies. Such future acquisitions could expose the Company to certain risks, such as difficulty of assimilating the operations; information systems and personnel of the acquired businesses; the potential disruption of the Company's ongoing business; the inability of management to maximize the financial and strategic position of the Company through the successful incorporation of acquired employees and customers; the maintenance of uniform standards, controls, procedures and policies; and the impairment of relationships with employees and customers as a result of any integration of new management personnel. There can be no assurance that any potential acquisition will be consummated or, if consummated, that it will not have a material adverse effect on the Company.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except for per share amounts)

Year ended March 31	1998	1997	1996
REVENUES			
Products	\$13,335	\$ 18,821	\$34,786
Maintenance	26,083	28,972	32,281
Service	13,159	17,030	21,490
Total Revenues	52,577	64,823	88,557
COST OF REVENUES			
Products	3,966	7,502	6,443
Maintenance	3,747	4,561	5,179
Services	11,324	16,041	18,270
Total Costs of Revenues	19,037	28,104	29,892
Gross Margin	33,540	36,719	58,665
OPERATING EXPENSES			
Selling, general and administrative	22,281	37,114	42,674
Research and development	8,897	14,994	15,875
Write-down of intangible assets	—	2,288	—
Restructuring charge	—	10,942	—
Total operating expenses	31,178	65,338	58,549
Income (loss) from operations	2,362	(28,619)	116
Other income (expense)	153	(931)	225
Income (loss) before income taxes	2,515	(29,550)	\$ 341
Provision for income taxes	79	—	30
Net Income (loss)	\$ 2,436	\$(29,550)	\$ 311
Dividends on preferred stock	(458)	—	—
Net income (loss) applicable to common shareholders	\$ 1,978	\$(29,550)	\$ 311
INCOME (LOSS) PER SHARE:			
Basic	\$ 0.11	\$ (1.70)	\$ 0.02
Diluted	\$ 0.09	\$ (1.70)	\$ 0.02
Shares used in computing income (loss) per share:			
Basic	17,857	17,344	15,557
Diluted	24,808	17,344	18,495

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

(In thousands except for share and per share amounts)

March 31	1998	1997
Assets		
CURRENT ASSETS		
Cash and cash equivalents	\$ 21,112	\$ 17,349
Accounts receivable, net of reserve for doubtful accounts of \$1,364 in 1998 and \$1,371 in 1997	12,706	11,359
Prepaid expenses and other current assets	838	1,504
TOTAL CURRENT ASSETS	34,656	30,212
Property and equipment, net	3,321	4,963
Intangible assets, net	583	2,281
Other assets	828	444
TOTAL ASSETS	\$ 39,388	\$ 37,900
Liabilities and Shareholders' Equity (Deficit)		
CURRENT LIABILITIES		
Accounts payable	\$ 2,079	\$ 1,774
Accrued expenses	11,657	14,455
Unearned revenue	12,136	15,102
Accrued restructuring	2,143	4,386
TOTAL CURRENT LIABILITIES	28,015	35,717
Long-term restructuring	2,063	2,955
TOTAL LIABILITIES	30,078	38,672
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 1998 and 1997 (liquidation value \$7 per share)		
	86	86
Senior Series C Convertible, issued and outstanding 1,010,348 in 1998 and 1,006,220 in 1997 (liquidation value \$9.95 per share)		
	101	101
Series 6% Convertible, issued and outstanding 7,625 in 1998		
	1	—
Common stock, par value \$0.1 per share, authorized 50,000,000 shares, issued and outstanding 18,155,309 in 1998 and 17,459,219 in 1997		
	182	175
Additional paid-in capital	93,369	85,513
Retained earnings (deficit)	(84,072)	(86,508)
Cumulative translation adjustment	(357)	(139)
TOTAL SHAREHOLDERS' EQUITY (DEFICIT)	9,310	(772)
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)	\$ 39,388	\$ 37,900

See Notes to Consolidated Financial Statements.

**CONSOLIDATED STATEMENTS OF CHANGES
IN SHAREHOLDERS' EQUITY (DEFICIT)**

(In thousands)

	Preferred Stock Senior Series B	Preferred Stock Senior Series C	Preferred Stock 6% Convertible	Common Stock	Additional Paid-In Capital	Retained Earnings (Deficit)	Cumulative Translation Adjustment	Total Shareholders' Equity (Deficit)
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 exercise	—	—	—	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 and obligations of Senior Series C Convertible preferred stock	—	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)
Net income	—	—	—	—	—	2,436	—	2,436
Common stock issued in connection with stock options exercised by employees	—	—	—	4	1,271	—	—	1,275
Issuance of Senior Series C Convertible	—	—	—	—	29	—	—	29
Common stock issued in connection with employee stock purchase plan	—	—	—	3	218	—	—	221
Issuance of Series 6% Convertible preferred stock	—	—	1	—	6,796	—	—	6,797
Dividends on preferred stock	—	—	—	—	(458)	—	—	(458)
Equity adjustment for foreign currency translation	—	—	—	—	—	—	(218)	(218)
Balances at March 31, 1998	\$ 86	\$101	\$ 1	\$182	\$93,369	\$(84,072)	\$(357)	\$ 9,310

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Year ended March 31	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$ 2,436	\$(29,550)	\$ 311
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Write-off of intangible assets	—	2,288	—
Restructuring charge	—	10,942	—
Gain from settlement of legal dispute	—	—	(1,230)
Depreciation and amortization expense	4,174	9,706	7,754
Loss from disposal of property and equipment	—	212	11
Income tax benefit from stock options exercised	—	—	30
Changes in assets and liabilities:			
(Increase) decrease in accounts receivable, net	(1,712)	8,126	2,950
(Increase) decrease in other assets	(322)	309	97
Decrease in accounts payable and accrued expenses	(1,519)	(172)	(1,068)
Increase (decrease) in unearned revenue	(2,737)	(730)	507
Decrease in other liabilities	(2,970)	(4,379)	(2,532)
Other, net	—	410	76
Net cash provided by (used in) operating activities	(2,650)	(2,838)	6,906
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(1,151)	(1,816)	(1,597)
Capitalized software development costs	—	(1,113)	(4,138)
Net cash used in investing activities	(1,151)	(2,929)	(5,735)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net proceeds from issuance of Senior Series C Convertible preferred stock	—	9,390	—
Net proceeds from issuance of Series 6% Convertible preferred stock	6,796	—	—
Net proceeds from issuance of common stock	1,496	1,250	2,780
Repayment of long-term debt and capital leases	(6)	(18)	(1,688)
Net cash provided by financing activities	8,286	10,622	1,092
Effect of exchange-rate changes on cash	(722)	(231)	21
Net increase (decrease) in cash and cash equivalents	3,763	4,624	2,284
Cash and cash equivalents at beginning of year	17,349	12,725	10,441
Cash and cash equivalents at end of year	\$21,112	\$ 17,349	\$12,725

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 The Company

Interleaf, Inc. and its subsidiaries (the "Company") develop and market software for the electronic assembly, management, retrieval, publishing and distribution of business-critical documents and information, and it is focusing its efforts for growth on content management and information publishing software and services.

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. Costs associated with insignificant vendor obligations are accrued. The Company also maintains a reserve for sales allowances 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. 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 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. See Note 13 on restricted cash.

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.

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 1998 and 1997 was \$180,000 and \$531,000, respectively and was not material for fiscal year 1996.

INCOME TAXES

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

INCOME (LOSS) PER SHARE

In 1997, the Financial Accounting Standards Board issued Statement No. 128, "Earnings Per Share," which is required to be adopted for fiscal years ending after December 15, 1997. All income (loss) per share amounts for all periods presented have been restated to conform to the SFAS 128 requirements. See Note 15 for the computation of basic and diluted income (loss) per share.

STOCK-BASED COMPENSATION

Statement of Financial Accounting Standards No. 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.

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 effect 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

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 restored the Company to profitable operations despite a continued decline in revenues. Management is committed to continue taking all appropriate and necessary actions to effect timely cost reductions in the event that anticipated revenue levels are not achieved during fiscal 1999. 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 its 1999 operating plan and existing cash balances, the Company will have sufficient cash to support operations during fiscal 1999.

PENDING ACCOUNTING PRONOUNCEMENTS:

The Financial Accounting Standards Board issued Statement No. 129, "Disclosure of Information about Capital Structures" in 1997. This Statement does not change the Company's disclosure requirements.

In 1997, the Financial Accounting Standards Board issued Statement No. 130 "Reporting Comprehensive Income" and Statement No. 131 "Disclosures about Segments of an Enterprise and Related Information," which will become effective for the Company in fiscal 1999. The Company is currently evaluating the effects of implementing these standards.

Also in 1997, the AICPA issued SOP 97-2, *Software Revenue Recognition*, which changes the requirements for revenue recognition effective for transactions that the Company will enter into beginning April 1, 1998. The Company believes that the adoption of SOP 97-2 will not have a material impact on its financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(continued)

Note 3 Property and Equipment

Property and equipment at March 31 consisted of the following:

(In thousands)	1998	1997
Office, demonstration and other equipment	\$27,252	\$27,739
Development equipment	12,815	12,654
Furniture	3,740	3,799
Leasehold improvements	1,819	1,637
	45,626	45,829
Less allowances for depreciation and amortization	42,305	40,866
	\$ 3,321	\$ 4,963

Note 4 Intangible Assets

The Company's intangible assets have historically consisted of purchased goodwill and capitalized software development costs. The Company's policy has been to amortize purchased goodwill to selling, general and administrative expense, and to amortize 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 12). As a result of a strategic product review, in fiscal year 1997 the Company wrote off capitalized software development costs of \$2.0 million in costs were associated with discontinued products or products with limited future revenue potential. The unamortized portion of capitalized software development costs was \$0.6 million and \$2.3 million at March 31, 1998 and 1997, respectively. Amortization and write-downs to net realizable value of capitalized software development costs were approximately \$1.7 million, \$5.0 million and \$3.2 million during fiscal 1998, 1997 and 1996, respectively.

Note 5 Credit Agreement

In August 1997, the Company's revolving line of credit with a major commercial lender expired and was not renewed. Although this credit facility was not utilized in either fiscal 1998 or 1997, available credit would have been secured by substantially all domestic assets of the Company. At March 31, 1998, the Company has a letter of credit for \$0.6 million, which is secured by the same amount of cash, from another major commercial lender which expires on July 31, 1998.

Note 6 Accrued Expenses

Accrued expenses at March 31 consisted of the following:

(In thousands)	1998	1997
Accrued compensation and related items	\$ 3,159	\$ 4,987
Taxes, other than income	754	2,414
Royalties	1,255	1,030
Rent	893	1,228
Other	5,596	4,796
	\$11,657	\$14,455

Note 7 Lease Commitments

The Company leases its headquarters and sales offices, and certain equipment under various operating leases, which expire through the year 2003. Rent expense amounted to approximately \$2.9 million, \$5.1 million and \$6.6 million during fiscal 1998, 1997 and 1996, respectively.

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

(In thousands) Year ended March 31	1999	2000	2001	2002	2003	Thereafter
Future minimum lease commitments on noncancelable leases	\$6,327	\$5,860	\$4,154	\$286	\$282	\$—
Future minimum sublease income	\$3,918	\$3,816	\$2,884	\$—	\$—	\$—

These future minimum lease commitments include approximately \$2.4 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 fiscal year 1998, the Company paid approximately \$3.1 million, net of sublease receipts, related to the fiscal 1997 and 1995 restructurings, compared to \$4.9 million paid during fiscal 1997. Expenditures for facility closures, primarily lease payments, net of sublease receipts, are expected to continue through December 2000. The Company continues to monitor its cost structure in light of current and future revenue levels.

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.

In connection with the Company's restructuring initiatives, the Company paid approximately \$6 million, \$2.7 million and \$7 million for employee termination benefits during fiscal 1998, 1997 and 1996, respectively. Payments for facility closures and related costs, net of sublease receipts, were approximately \$1.9 million, \$1.4 million and \$1.3 million during fiscal 1998, 1997 and 1996, 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:

(In thousands)	1998	1997	1996
Current:			
Federal	\$ 79	\$ —	\$ 30
State	—	—	—
Foreign	—	—	—
Total Current	79	—	30
Deferred:			
Federal	—	—	—
State	—	—	—
Total Deferred	—	—	—
	\$ 79	\$ —	\$ 30

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

(In thousands)	1998	1997	1996
Domestic	\$ 4,458	\$(21,586)	\$ 3,793
Foreign	(2,022)	(7,964)	(3,452)
	\$ 2,436	\$(29,550)	\$ 341

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(continued)

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:

(In thousands)	1998	1997	1996
Computed at federal statutory rate	\$ 814	\$(10,047)	\$ 116
Loss for which no tax benefit was realized	—	9,151	—
Nondeductible amortization	—	—	51
Nondeductible write-downs	—	778	—
Other nondeductible expenses	102	118	66
Benefit of net operating loss carryforwards	(837)	—	(195)
Other, net	—	—	(8)
	\$ 79	\$ —	\$ 30

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:

(In thousands)	1998	1997	1996
Deferred tax assets:			
Net operating loss carryforwards	\$ 24,138	\$ 22,897	\$ 14,919
Tax credit carryforwards	7,376	7,150	7,120
Accrued rent	344	473	601
Reserve for doubtful accounts receivable, vacation and other accruals	950	864	401
Restructuring	1,384	2,555	392
Total deferred tax assets	34,192	33,939	23,433
Deferred tax asset valuation allowance	(34,079)	(33,619)	(21,294)
	113	320	2,139
Deferred tax liabilities:			
Capitalized software development costs	(113)	(320)	(1,891)
Depreciation	—	—	(225)
Other	—	—	(23)
Total deferred tax liabilities	(113)	(320)	(2,139)
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 \$0.4 million and \$12.3 million during fiscal 1998 and 1997, respectively.

At March 31, 1998, the Company and its subsidiaries had net operating loss carryforwards of approximately \$63 million that are available to offset future taxable income. The loss carryforwards are attributable to operations in several tax jurisdictions and expire in fiscal 1999 and thereafter. In addition, the Company has research and development and other tax credit carryforwards of approximately \$7 million, which are available to reduce future federal and state income tax liabilities. The tax credit carryforwards expire in fiscal 1999 and thereafter. No tax payments were made in fiscal 1998 or fiscal 1997. During fiscal 1996, the Company made income tax payments of approximately \$0.3 million.

Note 10 Shareholders' Equity

SERIES A

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 ("Series A"), 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.

SERIES B

The Company issued 2,142,857 shares of its Senior Series B Convertible Preferred Stock ("Series B"), at \$7.00 per share. Under the terms of the Series B, the holders have a liquidation preference of \$7.00 per share over the holders of Common Stock, but this preference is subordinate to the liquidation preference of the holders of Series C and D, described below. 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 as a single class on all matters submitted to 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.

Each Series B share is convertible into 1.34375 shares of common stock. Series B holders converted 0, 61,393 and 805,269 shares of Series B Convertible Preferred Stock into shares of the Company's common stock during fiscal 1998, 1997 and 1996, respectively.

The Series B stock may be redeemed at any time by the Company at \$21.00 per share, 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.

SERIES C

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 Series C investment agreement, the Company issued an additional 5,444 Series C shares. 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 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 holders 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 and common stock, and pari passu with the Series D holders (described below). 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 has registered sufficient shares of common stock to satisfy the conversion requirements of the Series C.

The Company may, at its option, redeem the Series C shares on or after October 16, 1999. The redemption premium is initially 25%, and decreases 5% per year each October until 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.

SERIES D

On September 30, 1997, the Company sold, in a private placement, 7,625 shares of Series 6% Convertible Preferred Stock ("Series D") at a price of \$1,000 per share, receiving proceeds of \$6.8 million, net of placement agent fees and transaction costs. In addition, the Company issued to the placement agent warrants to purchase 763 Series D shares at an exercise price of \$1,000 per share. These warrants are exercisable for a period of five years commencing September 30, 1997.

The Company has registered sufficient shares of common stock to satisfy the conversion requirements of the Series D.

Pursuant to its agreements with the Series D holders and with NASDAQ, the Company on December 17, 1997 received shareholder approval of the issuance of the Series D shares.

Each Series D share is entitled to receive dividends, payable annually on September 30 of each year, when and as declared by the Company's Board of Directors, at the rate of 6% per annum in preference to any payment made on any shares of Common Stock or any other class or series of capital stock of the Company other than the Series C, which has rights to dividends pari passu with the Series D. Such dividends accrue from day to day whether or not earned or declared. Any dividend payable after the date of issuance of the Series D may be paid (i) in additional Series D shares valued at \$1,000.00 per share, or (ii) upon proper notice, in cash. Each Series D share is also entitled to a liquidation preference of \$1,000.00 per share, plus any accrued but unpaid dividends in preference to any other class or series of capital stock of the Company (except the Series C, which is pari passu with the Series D). Except as otherwise provided by applicable law, Series D holders have no voting rights.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(continued)

Commencing on December 29, 1997, at least 10% and up to 25% (depending upon the price at which the Common Stock is trading) of the number of Series D shares held of record by each holder on such day became convertible into shares of Common Stock, and thereafter on the successive monthly anniversaries of such day additional Series D shares shall become convertible (with the additional amount varying from 10% to 25% of the number of Series D shares held of record by such holder on such day depending upon the price at which Common Stock is trading) except that in any month when the highest of the Common Stock's daily low trading prices is \$2.50 or less, not more than 10% of each holder's Series D shares held of record on such day shall be convertible.

The number of shares of Common Stock issuable upon conversion of Series D shares will equal the liquidation preference of the shares being converted divided by the then-effective conversion price (the "Conversion Price"). The Conversion Price through April 30, 1998 was \$5.50. The Conversion Price between May 1, 1998 and January 31, 1999 shall be the lowest trading price of the Common Stock during the twenty-two (22) consecutive trading days immediately preceding the date of conversion, reduced by the Applicable Percentage, described below, except that the Conversion Price shall be not less than \$1.50 prior to November 1, 1998. The "applicable percentage" is dependent upon the time which has passed from original issuance to the date of measurement, being 9.8% starting on May 1, 1998 and increasing in each subsequent month to 11.1%, 12.4%, 13.7% and 15%. At any date after February 1, 1999, the Conversion Price will be the lesser of (a) 85% of the average of low daily trading price of the Common Stock for all the trading days during November 1998 through January 1999 (provided that in no event shall this amount be less than \$2.8126), or (b) 85% of the average of the lowest daily trading price of the Common Stock during the twenty-two (22) consecutive trading days immediately preceding the date of conversion (the "Conversion Cap"). The Conversion Price is at all times also subject to adjustment for customary anti-dilution events such as stock splits, stock dividends, reorganizations and certain mergers affecting the Common Stock. On September 30, 2003, all of the then outstanding Series D shares will be automatically converted into shares of Common Stock at the then-applicable Conversion Price. No Series D holder will be entitled to convert any Series D shares into shares of Common Stock if, following such conversion, the holder and its affiliates (within the meaning of the Securities Exchange Act of 1934) will be the beneficial owners (as defined in Rule 13d-3 thereunder) of 10% or more of the outstanding shares of Common Stock.

Following conversion of Series D shares into shares of Common Stock, the holders of such shares of Common Stock have agreed to be limited on resales of such shares to the greatest of: (i) 10% of the average daily trading volume of the Common Stock for the five trading days preceding any such sales; (ii) 12,000 shares; or (iii) 10% of the trading volume for the Common Stock on the date of any such sale. Furthermore, the Company has the right, upon proper notice, if the Conversion Price falls below Three Dollars (\$3.00) (or such other price as is set by the Company in accordance with certain notice provisions), and subject to certain other conditions, to honor any conversion request by a cash payment in lieu of the issuance of Common Stock in an amount equal to the proceeds which would otherwise have been received by the holder if conversion were in fact made into Common Stock and such Common Stock were sold at the high trade price on the trading day immediately preceding the date that the conversion notice is received (the "Green Floor").

WARRANTS

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 shares of common stock in connection with the exercise of warrants during fiscal 1996. 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, officers and directors. The Board of Directors determines the option price, the option term, and the vesting period for options granted. Incentive stock options are granted at a price not less than the fair market value on the date of grant. In June 1993, the Board of Directors adopted the 1993 Stock Option Plan (the "1993 Plan"), which initially provided for a maximum of 750,000 shares of common stock to be issued and sold under the plan. In August 1995, August 1997 and February 1998 the Board of Directors approved amendments to the 1993 Plan to increase the number of shares available for issuance under the plan by 750,000, 600,000 and 1,300,000 shares, respectively. On July 14, 1994, the Board of Directors adopted the 1994 Employee Stock Option Plan (the "1994 Plan"), which initially provided for a maximum of 750,000 shares of common stock to be issued and sold under the 1994 Plan. In May 1996 and October 1996 the Board of Directors approved amendments to the 1994 Plan to increase the number of shares available for issuance under the plan by 750,000 and 1,000,000 shares, respectively. In February 1998, the Board of Directors resolved that no additional shares would be issued under the 1994 Plan, that all future option grants would be issued under the 1993 Plan, and that the 1993 Plan would be administered in a broadly based fashion. In January 1997 and February 1998 the Company adopted the 1997 Key Man Stock Option Plan and Agreement, and the 1998 Key Man Stock Option Plan and Agreement, which provided for a maximum of 950,000 shares of common stock to be issued and sold. As of March 31, 1998, options to purchase an aggregate of 950,000 shares had been granted, and no further shares were available for grant.

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 may not be exercised until March 12, 1997. 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. On June 20, 1997, the Board of Directors authorized a repricing program which allowed employees to elect to reprice all or some of their outstanding options, ranging in price from \$2.00 to \$8.25 per share, to the June 20, 1997 closing price of \$1.25. Approximately 1.2 million shares were repriced.

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

(In thousands, except price range of shares)	Number of Shares	Price Range of Shares	Weighted Average Price per Share
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	2.03 - 10.75	\$2.75
Granted	2,282	.94 - 3.63	2.17
Exercised	(448)	.94 - 5.50	2.82
Cancelled	(942)	.94 - 10.75	3.25
Outstanding at March 31, 1998	3,831	\$.94 - 7.37	\$3.07

At March 31, 1998, there were approximately 1,797,000 shares available for grant. Options exercisable at March 31, 1998, 1997 and 1996 were approximately 335,000, 1,238,000 and 912,000, 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, under which 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. Under that plan, each newly elected non-employee director received 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 received a grant of 5,000 additional options. In December 1997, the Board of Directors amended this plan, subject to shareholder approval, to provide that newly elected non-employee directors will receive a grant of 25,000 shares, and on each April 1 each non-employee director will automatically receive a grant of an additional 7,500 shares. During fiscal 1998 and 1997, no options were exercised. At March 31, 1998, there were options outstanding to purchase 145,000 shares and no shares were available for grant. Options exercisable at March 31, 1998, 1997 and 1996 were 15,000, 70,000 and 105,000, 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 Compensation." Accordingly, no compensation cost has been recognized for the Company's stock option plans and employee stock purchase plan.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(continued)

Had compensation cost been determined based on the fair value at the grant dates for awards under those plans in fiscal 1998, 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:

(In thousands, except per share amounts)	1998	1997	1996
Net income (loss)—as reported	\$2,436	\$(29,550)	\$ 311
Net income (loss)—pro forma	1,651	(29,858)	228
Earnings (loss) per share—as reported—Basic	0.11	(1.70)	0.02
Earnings (loss) per share—pro forma—Basic	0.09	(1.72)	0.02
As reported—diluted (except when anti-dilutive)	0.09	(1.70)	0.01
Pro forma-diluted (except when anti-dilutive)	0.07	(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:

	1998	1997	1996
Expected life (years)	4	4	4
Risk-free interest rate	5.47%–6.83%	6.38%	5.79%
Volatility	78.9%	73.8%	73.8%
Dividend yield	—	—	—

The weighted-average grant-date fair value of options granted during 1998, 1997 and 1996 was \$1.11, \$1.84 and \$3.12, respectively. The following table summarizes information about stock options outstanding at March 31, 1998:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding at 3/31/98	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable at 3/31/98	Weighted Average Exercise Price
\$ 0.94	615	9.1	0.94	—	—
\$1.19–1.25	2001	8.8	1.25	181	1.25
\$2.50–2.75	737	7.5	2.69	139	2.58
\$3.13–3.63	461	9.7	3.27	—	—
\$7.37–8.25	17	8.0	7.99	15	8.10

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. On April 9, 1998, this plan was amended by the Board of Directors to provide that the final offering period will terminate on November 5, 1998, rather than April 30, 1999 as originally provided. Shares issued to employees during fiscal 1998, 1997 and 1996 were approximately 251,000, 183,000 and 157,000, respectively. At March 31, 1997, approximately 16,944,000 shares of common stock were reserved for issuance, primarily related to the Series B, Series C and Series D, 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 no contributions during fiscal 1998, 1997 and 1996.

Note 12 Acquisition

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 \$2.7 million. TLA provided 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 13 Contingencies

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

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, 1998 and 1997 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.

Note 14 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, 1998, 1997 and 1996, and for the years then ended is as follows:

(In thousands)				
March 31, 1998 and for the year then ended	U.S.	Non-U.S.	Eliminations	Total
Sales to unaffiliated customers	\$34,582	\$17,080	\$ 915	\$52,577
Intercompany royalties and transfers	4,610	4	(4,614)	—
Net revenues	39,192	17,084	(3,699)	52,577
Income (loss) from operations	3,231	(1,784)	915	2,362
Identifiable assets	66,044	16,824	(43,480)	39,388

(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

(In thousands)				
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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(continued)

Note 15 Income (Loss) Per Share

The following table sets forth the computation of basic and diluted income (loss) per share:

	1998	1997	1996
Numerator:			
Net Income	\$ 2,436	\$(29,550)	\$ 311
Preferred Stock Dividends:			
Senior Series C Convertible	(230)	—	—
Series 6% Convertible	(228)	—	—
	(458)	—	—
Numerator for basic income (loss) per share:			
income (loss) available to common shareholders	1,978	(29,550)	311
Effect of dilutive securities:			
Senior Series C Convertible	230	—	—
Numerator for diluted income (loss) per share: income (loss) available to common shareholders after assumed conversion	\$ 2,208	\$(29,550)	\$ 311
Denominator:			
Denominator for basic income (loss) per share:			
Weighted average shares	17,857	17,344	15,557
Effect of dilutive securities:			
Employee stock options	1,646	—	1,005
Director stock options	—	—	24
Employee stock purchase plan	101	—	54
Warrants	13	—	97
Senior Series B Convertible Preferred Stock	1,158	—	1,758
Senior Series C Convertible Preferred Stock	4,033	—	—
Dilutive potential common shares	6,951	—	2,938
Denominator for diluted income (loss) per share: adjusted weighted average shares and assumed conversions	24,808	17,344	18,495
Basic income (loss) per share	\$ 0.11	\$ (1.70)	\$ 0.02
Diluted income (loss) per share	\$ 0.09	\$ (1.70)	\$ 0.02

For additional disclosures regarding outstanding preferred stock, employee and director stock options, the employee stock purchase plan, and the warrants see Note 10.

Options to purchase 2,185,000 shares of common stock were outstanding at March 31, 1998 but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares and, therefore, the effect would be antidilutive. In 1998, the Series D was not included in the computation of diluted earnings per share because the effect would be antidilutive. In 1997, no dilutive securities were included in the computation of diluted earnings per share because the Company had a net loss, and the effect would have been antidilutive.

VALUATION AND QUALIFYING ACCOUNTS

(In thousands)

COL. A	COL. B	COL. C	COL. D	COL. E	COL. F
Description	Balance at Beginning of Period	Additions to Costs and Expenses	Other Additions—Describe ⁽¹⁾	Deductions—Describe ⁽²⁾	Balance at End of Period
Year ended March 31, 1996:					
Deducted from asset accounts					
Allowance for doubtful accounts	\$1,953	\$630	\$300	\$(1,188)	\$1,695
Year ended March 31, 1997:					
Deducted from asset accounts					
Allowance for doubtful accounts	\$1,695	\$304	\$ —	\$(628)	\$1,371
Year ended March 31, 1998:					
Deducted from asset accounts					
Allowance for doubtful accounts	\$1,371	\$224	\$ —	\$(231)	\$1,364

(1) Reclassified to allowance for doubtful accounts from accrued expenses

(2) Write-off of uncorrectable accounts receivable and effect of foreign exchange rate fluctuations

REPORT OF ERNST & YOUNG LLP,
INDEPENDENT AUDITORS

Board of Directors
Interleaf, Inc.

We have audited the accompanying consolidated balance sheets of Interleaf, Inc. as of March 31, 1998 and 1997, 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, 1998. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule 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, 1998 and 1997, and the consolidated results of its operations and its cash flows for each of the three years in the period ended March 31, 1998, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

Ernst & Young LLP

Boston, Massachusetts
May 13, 1998

SUPPLEMENTAL FINANCIAL INFORMATION

(Unaudited)

The following summarizes unaudited selected quarterly results of operations for the years ended March 31, 1998 and 1997 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 1998						
Revenues		\$12,826	\$13,118	\$13,424	\$13,209	\$52,577
Gross Margin		8,311	8,277	8,440	8,512	33,540
Net income		386	449	726	875	2,436
Net income per share:	Basic	0.02	0.03	0.04	0.04	0.11
	Diluted	0.02	0.02	0.03	0.03	0.09
Common stock prices:						
High		1 ¹¹ / ₁₆	3 ¹ / ₂	3 ³ / ₃₂	3 ³ / ₄	
Low		2 ⁹ / ₃₂	1 ⁷ / ₁₆	2 ⁵ / ₈	2 ¹ / ₄	
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, c}	(29,550)
Net income per share:	Basic	(0.22)	(0.59)	(0.54)	(0.35)	(1.70)
	Diluted	(0.22)	(0.59)	(0.54)	(0.35)	(1.70)
Common stock prices:						
High		8 ⁵ / ₈	5 ⁵ / ₈	3 ⁵ / ₈	2 ⁷ / ₁₆	
Low		6 ¹ / ₂	2 ¹ / ₈	1 ⁵ / ₈	1 ⁵ / ₈	

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 world-wide employment and facility costs.

^b Includes a \$2.3 million write-off of goodwill related to the TLA acquisition.

^c 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.

^d Includes a \$1.5 million reserve for sales allowances during the quarter.



CONTENT MANAGEMENT IS A CONTACT SPORT

corporate information

Corporate Officers

Jaime W. Ellertson
President and Chief Executive Officer

Gary R. Phillips
Vice President, Sales

Christopher McKee
Vice President, Europe,
Middle East and Africa

Michael L. Torto
Vice President, Marketing

Robert A. Fisher
Vice President, Customer Support

Peter J. Rice
Vice President, Finance and
Administration, Chief Financial
Officer and Treasurer

John Pavlov
Vice President, Product Development

Craig Newfield
Vice President, General Counsel
and Clerk

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. Cowan
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

John A. Lopiano
Xerox Corporate Vice President and
President Xerox Production
Systems Group

George D. Potter, Jr.
President
Quality Systems International

Shareholder Information

Common Stock

Interleaf's common stock is traded
on the Nasdaq National Market
under the trading symbol LEAF

Annual Meeting

The Annual Meeting of Shareholders
will be held August 24, 1998 at 10:00 a.m.
at Interleaf, Inc., 62 Fourth Avenue,
Waltham, MA 02451

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 02451

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.
P.O. Box 644
Mail Stop: 45-02-64
Boston, MA 02102-0644

Investor Relations

To receive further information about
Interleaf, please contact:
Investor Relations
617-290-0710, ext. 8138

Independent Auditors

Ernst & Young LLP
Boston, MA

Legal Counsel

Brown, Rudnick, Freed & Gesmer, P.C.
Boston, MA

Corporate Directory

Corporate Headquarters

Interleaf, Inc.
62 Fourth Avenue
Waltham, MA 02451
USA

Field Offices:

North America

El Segundo, Redwood City, California;
Greenbelt, Maryland; Waltham,
Massachusetts; Dallas, Texas;
Ottawa, Ontario

International

Sydney, Australia; Brussels, Belgium; Paris,
France; Frankfurt, Germany; Milan, Italy;
Tokyo, Japan; London, UK

WORLD HEADQUARTERS

Interleaf, Inc.
62 Fourth Avenue
Waltham, Massachusetts 02451
USA

Interleaf Locations

EUROPEAN HEADQUARTERS

Persimmon House
Brooklands Business Park
Weybridge, Surrey
KT 13 0YP
United Kingdom
44-1-932-356800

INTERNATIONAL OFFICES &

PARTNER LOCATIONS

Australia • Belgium • Canada • France •
Germany • Italy • Japan • Mexico • United Kingdom

Interleaf