

HARTFORD FINANCIAL SERVICES GROUP INC/DE

Form 10-K

February 23, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K**

(Mark One)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 001-13958

THE HARTFORD FINANCIAL SERVICES GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware

**(State or other jurisdiction of
incorporation or organization)**

13-3317783

**(I.R.S. Employer
Identification No.)**

One Hartford Plaza, Hartford, Connecticut 06155

(Address of principal executive offices)

(860) 547-5000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: the following, all of which are listed on the New York Stock Exchange, Inc.

Common Stock, par value \$0.01 per share

6.1% Notes due October 1, 2041

Securities registered pursuant to Section 12(g) of the Act:

4.7% Notes due September 1, 2007

5.55% Notes due August 16, 2008

6.375% Notes due November 1, 2008

5.663% Notes due November 16, 2008

7.9% Notes due June 15, 2010

5.25% Notes due October 15, 2011

4.625% Notes due July 15, 2013

4.75% Notes due March 1, 2014

7.3% Debentures due November 1, 2015

5.50% Notes due October 15, 2016

5.95% Notes due October 15, 2036

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☒

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements

incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The aggregate market value of the shares of Common Stock held by non-affiliates of the registrant as of June 30, 2006 was approximately \$25,666,539,000, based on the closing price of \$84.60 per share of the Common Stock on the New York Stock Exchange on June 30, 2006.

As of February 16, 2007, there were outstanding 320,217,940 shares of Common Stock, \$0.01 par value per share, of the registrant.

Documents Incorporated by Reference:

Portions of the registrant's definitive proxy statement for its 2007 annual meeting of shareholders are incorporated by reference in Part III of this Form 10-K.

The Hartford Financial Services Group, Inc.
Annual Report on Form 10-K
For the Fiscal Year Ended December 31, 2006
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PART I

Item 1. BUSINESS

(Dollar amounts in millions, except for per share data, unless otherwise stated)

General

The Hartford Financial Services Group, Inc. (together with its subsidiaries, The Hartford or the Company) is a diversified insurance and financial services company. The Hartford, headquartered in Connecticut, is among the largest providers of investment products, individual life, group life and group disability insurance products, and property and casualty insurance products in the United States. Hartford Fire Insurance Company, founded in 1810, is the oldest of The Hartford's subsidiaries. The Hartford writes insurance in the United States and internationally. At December 31, 2006, total assets and total stockholders' equity of The Hartford were \$326.7 billion and \$18.9 billion, respectively.

Organization

The Hartford strives to maintain and enhance its position as a market leader within the financial services industry and to maximize shareholder value. The Company pursues a strategy of developing and selling diverse and innovative products through multiple distribution channels, continuously developing and expanding those distribution channels, achieving cost efficiencies through economies of scale and improved technology, maintaining effective risk management and prudent underwriting techniques and capitalizing on its brand name and customer recognition of The Hartford Stag Logo, one of the most recognized symbols in the financial services industry.

As a holding company that is separate and distinct from its subsidiaries, The Hartford Financial Services Group, Inc. has no significant business operations of its own. Therefore, it relies on the dividends from its insurance companies and other subsidiaries as the principal source of cash flow to meet its obligations. Additional information regarding the cash flow and liquidity needs of The Hartford Financial Services Group, Inc. may be found in the Capital Resources and Liquidity section of Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

The Company maintains a retail mutual fund operation, whereby the Company, through wholly-owned subsidiaries, provides investment management and administrative services to The Hartford Mutual Funds, Inc. and The Hartford Mutual Funds II, Inc. (The Hartford mutual funds) families of 52 mutual funds and 1 closed end fund. Investors can purchase shares in The Hartford mutual funds, all of which are registered with the Securities and Exchange Commission in accordance with the Investment Company Act of 1940. The Hartford mutual funds are owned by the shareholders of those funds and not by the Company.

Reporting Segments

The Hartford is organized into two major operations: Life and Property & Casualty, each containing reporting segments. Within the Life and Property & Casualty operations, The Hartford conducts business principally in ten operating segments. Additionally, Corporate primarily includes the Company's debt financing and related interest expense, as well as certain capital raising activities and purchase accounting adjustments.

Life is organized into six reportable operating segments: Retail Products Group (Retail), Retirement Plans, Institutional Solutions Group (Institutional), Individual Life, Group Benefits and International.

Retail offers individual variable and fixed market value adjusted (MVA) annuities, retail mutual funds, 529 college savings plans, Canadian and offshore investment products.

Retirement Plans provides products and services to corporations pursuant to Section 401(k) and products and services to municipalities and not-for-profit organizations under Section 457 and 403(b) of the IRS code. Retirement also offers mutual funds to individual investors.

Institutional primarily offers institutional liability products, including stable value products and institutional annuities (primarily terminal funding cases), as well as variable Private Placement Life Insurance (PPLI) owned by corporations and high net worth individuals. Within stable value, Institutional has an investor note program that offers both institutional and retail investor notes. Institutional and Retail notes are sold as funding agreement backed notes through trusts and may also be issued directly from the company to investors. Institutional also offers mutual funds to institutional investors. Furthermore, Institutional offers additional individual products including structured settlements, consumer notes and single premium immediate annuities and longevity assurance.

Individual Life sells a variety of life insurance products, including variable universal life, universal life, interest sensitive whole life and term life.

Group Benefits provides employers, associations, affinity groups and financial institutions with group life, accident and disability coverage, along with other products and services, including voluntary benefits, group retiree health, and medical stop loss.

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International, which has operations located in Japan, Brazil, Ireland and the United Kingdom, provides investments, retirement savings and other insurance and savings products to individuals and groups outside the United States and Canada.

Life includes in an Other category its leveraged PPLI product line of business; corporate items not directly allocated to any of its reportable operating segments; net realized capital gains and losses on fixed maturity sales generated from movements in interest rates, less amortization of those gains or losses back to the reportable segments; net realized capital gains and losses generated from credit related events, less a credit risk fee charged to the reportable segments; net realized capital gains and losses from non-qualifying derivative strategies (including embedded derivatives) other than the net periodic coupon settlements on credit derivatives and the net periodic coupon settlements on the cross currency swaps used to economically hedge currency and interest rate risk generated from sales of the Company's yen based fixed annuity, which are allocated to the reportable segments; the mark-to-market adjustment for the equity securities held for trading reported in net investment income and the related change in interest credited reported as a component of benefits, losses and loss adjustment expenses since these items are not considered by the Company's chief operating decision maker in evaluating the International results of operations; and intersegment eliminations.

Property & Casualty is organized into four reportable operating segments: the underwriting segments of Business Insurance, Personal Lines, and Specialty Commercial (collectively "Ongoing Operations"); and the Other Operations segment.

Business Insurance provides standard commercial insurance coverage to small commercial and middle market commercial businesses primarily throughout the United States. This segment offers workers' compensation, property, automobile, liability, umbrella and marine coverages. Commercial risk management products and services are also provided.

Personal Lines provides automobile, homeowners' and home-based business coverages to the members of AARP through a direct marketing operation and to individuals who prefer local agent involvement through a network of independent agents in the standard personal lines market. Personal Lines also operates a member contact center for health insurance products offered through AARP's Health Care Options.

The Specialty Commercial segment offers a variety of customized insurance products and risk management services. Specialty Commercial provides standard commercial insurance products including workers' compensation, automobile and liability coverages to large-sized companies. Specialty Commercial also provides professional liability, fidelity, surety, specialty casualty and livestock coverages, as well as core property and excess and surplus lines coverages not normally written by standard lines insurers. Alternative markets, within Specialty Commercial, provides insurance products and services primarily to captive insurance companies, pools and self-insurance groups. In addition, Specialty Commercial provides third party administrator services for claims administration, integrated benefits, loss control and performance measurement through Specialty Risk Services, a subsidiary of the Company.

The Other Operations segment consists of certain property and casualty insurance operations of The Hartford which have discontinued writing new business and includes substantially all of the Company's asbestos and environmental exposures.

The measure of profit or loss used by The Hartford's management in evaluating the performance of its Life segments is net income. Likewise, within Property & Casualty, net income is the measure of profit or loss used in evaluating the performance of Total Property & Casualty, Ongoing Operations and the Other Operations segment. Within Ongoing Operations, the underwriting segments of Business Insurance, Personal Lines and Specialty Commercial are evaluated by The Hartford's management primarily based upon underwriting results. Underwriting results represent premiums earned less incurred losses, loss adjustment expenses and underwriting expenses. The sum of underwriting results, other revenues, net investment income, net realized capital gains and losses, other expenses, and related income taxes is net income (loss).

Life

Life's business is conducted by Hartford Life, Inc. ("Hartford Life" or "Life"), an indirect subsidiary of The Hartford, headquartered in Simsbury, Connecticut, a leading financial services and insurance organization. Hartford Life provides (i) retail and institutional investment products, including variable annuities, fixed market value adjusted

(MVA) annuities, mutual funds, private placement life insurance, which includes life insurance products purchased by a company on the lives of its employees, and retirement plan services for the savings and retirement needs of over 5.0 million customers, (ii) life insurance for wealth protection, accumulation and transfer needs for approximately 754,000 customers, (iii) group benefits products such as group life and group disability insurance for the benefit of millions of individuals, and (iv) fixed and variable annuity products through its international operations for the savings and retirement needs of approximately 450,000 customers. Life is one of the largest sellers of individual variable annuities, variable universal life insurance and, group life and disability insurance in the United States. Life's strong position in each of its core businesses provides an opportunity to increase the sale of Life's products and services as individuals increasingly save and plan for retirement, protect themselves and their families against the financial uncertainties associated with disability or death and engage in estate planning.

Hartford Life is among the largest consolidated life insurance groups in the United States based on statutory assets as of December 31, 2006. In the past year, Life's total assets under management, which include \$43.7 billion of third party assets invested in Life's mutual funds and 529 College Savings Plans, increased 18% to \$327.5 billion at December 31, 2006 from \$276.5 billion at December 31, 2005.

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Life generated revenues of \$14.1 billion, \$15.0 billion and \$11.4 billion in 2006, 2005 and 2004, respectively. Additionally, Life generated net income of \$1.4 billion, \$1.2 billion and \$1.4 billion in 2006, 2005 and 2004, respectively.

Customer Service, Technology and Economies of Scale

Life maintains advantageous economies of scale and operating efficiencies due to its growth, attention to expense and claims management and commitment to customer service and technology. These advantages allow Life to competitively price its products for its distribution network and policyholders. In addition, Life utilizes technology to enhance communications within Life and throughout its distribution network in order to improve Life's efficiency in marketing, selling and servicing its products and, as a result, provides high-quality customer service. In recognition of excellence in customer service for individual annuities, Hartford Life was awarded the 2006 Annuity Service Award by DALBAR Inc., a recognized independent financial services research organization, for the eleventh consecutive year. Hartford Life is the only company to receive this prestigious award in every year of the award's existence. Also, in 2006 Life earned its fourth DALBAR Award for Mutual Fund service, as well as, Retirement Plan Service which recognizes Hartford Life as the No. 1 service provider of mutual funds and retirement plans in the industry. Continuing the trend of service excellence, Life's Individual Life segment won its sixth consecutive DALBAR award for service of life insurance customers. Additionally, Life's Individual Life segment also won its fifth DALBAR Financial Intermediary Service Award in 2006.

Risk Management

Life's product designs, prudent underwriting standards and risk management techniques are structured to protect it against disintermediation risk, greater than expected mortality and morbidity experience, foreign currency risk and, risks associated with certain product features, specifically the guaranteed minimum death benefit (GMDB), guaranteed minimum withdrawal benefit (GMWB) and guaranteed minimum income benefit (GMIB) offered with variable annuity products. As of December 31, 2006, Life had limited exposure to disintermediation risk on approximately 98% of its domestic life insurance and annuity liabilities through the use of separate accounts, MVA features, policy loans, surrender charges and non-surrenderability provisions. Life effectively utilizes prudent underwriting to select and price insurance risks and regularly monitors mortality and morbidity assumptions to determine if experience remains consistent with these assumptions and to ensure that its product pricing remains appropriate. Life also enforces disciplined claims management to protect itself against greater than expected morbidity experience. Life uses reinsurance structures and has modified benefit features to mitigate the mortality exposure associated with GMDB. Life also uses reinsurance and derivative instruments to attempt to minimize equity risk volatility on GMWB and, to some degree, foreign currency risk associated with the GMIB liability.

Retail

The Retail segment focuses, through the sale of individual variable and fixed annuities, mutual funds and other investment products, on the savings and retirement needs of the growing number of individuals who are preparing for retirement or who have already retired. This segment's assets under management grew to \$164.9 billion at December 31, 2006 from \$145.9 billion at December 31, 2005 and from \$137.1 billion at December 31, 2004. Retail generated revenues of \$3.5 billion, \$3.2 billion and \$3.0 billion in 2006, 2005 and 2004, respectively, of which individual annuities accounted for \$2.8 billion, \$2.7 billion and \$2.6 billion for 2006, 2005 and 2004, respectively. Net income in Retail was \$628, \$622 and \$503 in 2006, 2005 and 2004, respectively.

Life sells both variable and fixed individual annuity products through a wide distribution network of national and regional broker-dealer organizations, banks and other financial institutions and independent financial advisors. Life is a market leader in the annuity industry with deposits of \$13.1 billion, \$11.5 billion and \$15.7 billion in 2006, 2005 and 2004, respectively. Life was among the largest sellers of individual retail variable annuities in the United States with deposits of \$12.1 billion, \$11.2 billion and \$15.0 billion in 2006, 2005 and 2004, respectively. In addition, Life continues to be the largest seller of individual retail variable annuities through banks in the United States.

Life's total account value related to individual annuity products was \$124.3 billion as of December 31, 2006. Of this total account value, \$114.4 billion, or 92%, related to individual variable annuity products and \$9.9 billion, or 8%, related primarily to fixed MVA annuity products. As of December 31, 2005, Life's total account value related to individual annuity products was \$115.5 billion. Of this total account value, \$105.3 billion, or 91%, related to

individual variable annuity products and \$10.2 billion, or 9%, related primarily to fixed MVA annuity products. As of December 31, 2004, Life's total account value related to individual annuity products was \$111.0 billion. Of this total account value, \$99.6 billion, or 90%, related to individual variable annuity products and \$11.4 billion, or 10%, related primarily to fixed MVA annuity products.

Life continues to emerge as a significant participant in the mutual fund business. Retail mutual fund assets were \$38.5 billion, \$29.1 billion and \$25.2 billion as of December 31, 2006, 2005 and 2004, respectively. Retail mutual fund sales were \$11.1 billion, \$5.8 billion and \$5.9 billion in 2006, 2005, and 2004, respectively.

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Principal Products

Individual Variable Annuities Life earns fees, based on policyholders' account values, for managing variable annuity assets, providing various death benefits and principal guarantees, and maintaining policyholder accounts. Life uses specified portions of the periodic deposits paid by a customer to purchase units in one or more mutual funds as directed by the customer, who then assumes the investment performance risks and rewards. As a result, variable annuities permit policyholders to choose aggressive or conservative investment strategies, as they deem appropriate, without affecting the composition and quality of assets in Life's general account. These products offer the policyholder a variety of equity and fixed income options, as well as the ability to earn a guaranteed rate of interest in the general account of Life. Life offers an enhanced guaranteed rate of interest for a specified period of time (no longer than twelve months) if the policyholder elects to dollar-cost average funds from Life's general account into one or more separate accounts. Principal guarantees include guaranteed minimum death and withdrawal benefits.

The majority of the contracts with the guaranteed death benefit feature are sold by the Retail Products Group segment. Hartford Life pays the greater of (1) account value at death, (2) the sum of all premium payments less prior withdrawals; or (3) the maximum anniversary value of the contract, plus any premium payments since the contract anniversary, minus any withdrawals following the contract anniversary. For certain guaranteed death benefits sold with variable annuity contracts beginning in June 2003, the Company pays the greater of (1) the account value at death; or (2) the maximum anniversary value; not to exceed the account value plus the greater of (a) 25% of premium payments, or (b) 25% of the maximum anniversary value of the contract. The GMWB provides the policyholder with a guaranteed remaining balance (GRB) if the account value is reduced to zero through a combination of market declines and withdrawals. The GRB is generally equal to premiums less withdrawals. However, annual withdrawals that exceed a specific percentage of the premiums paid may reduce the GRB by an amount greater than the withdrawals and may also impact the guaranteed annual withdrawal amount that subsequently applies after the excess annual withdrawals occur. For certain of the withdrawal benefit features, the policyholder also has the option, after a specified time period, to reset the GRB to the then-current account value, if greater. In addition, the Company has introduced features for contracts issued beginning in the fourth quarter of 2005, that allows the policyholder to receive the guaranteed annual withdrawal amount for as long as they are alive. In this new feature, in all cases the contract holder or their beneficiary will receive the GRB and the GRB is reset on an annual basis to the maximum anniversary account value subject to a cap.

Policyholders may make deposits of varying amounts at regular or irregular intervals and the value of these assets fluctuates in accordance with the investment performance of the funds selected by the policyholder. To encourage persistency, many of Life's individual variable annuities are subject to withdrawal restrictions and surrender charges. Surrender charges range up to 8% of the contract's deposits less withdrawals, and reduce to zero on a sliding scale, usually within seven years from the deposit date. Individual variable annuity account values of \$114.4 billion as of December 31, 2006, have grown from \$105.3 billion as of December 31, 2005, primarily due to equity market appreciation. Approximately 95% and 94% of the individual variable annuity account values were held in separate accounts as of December 31, 2006 and 2005, respectively.

The assets underlying Life's variable annuities are managed both internally and by independent money managers, while Life provides all policy administration services. Life utilizes a select group of money managers all of which are among the nation's most successful investment managers. Furthermore, each money manager is compensated on sales of Life's products and enhance the marketability of Life's annuities and the strength of its product offerings. Hartford Leaders, which is a multi-manager variable annuity that combines the product manufacturing, wholesaling and service capabilities of Life with the investment management expertise of American Funds, Franklin Templeton Group, AIM Investments and MFS Investment Management, is an industry leader in terms of retail sales. In 2005, the Director M variable annuity was introduced to combine the product manufacturing, wholesaling and service capabilities of Life with the investment management expertise of Wellington Management Company, LLP (Wellington) and Hartford Investment Management Company (HIMCO), the two money managers for the former Director product, as well as an additional six premier investment firms: AllianceBernstein, Fidelity Investments, Lord Abbett, Oppenheimer Funds, Putnam and Van Kampen.

Fixed MVA Annuities Fixed MVA annuities are fixed rate annuity contracts which guarantee a specific sum of money to be paid in the future, either as a lump sum or as monthly income. In the event that a policyholder surrenders a policy prior to the end of the guarantee period, the MVA feature increases or decreases the cash surrender value of the annuity in respect of any interest rate decreases or increases, respectively, thereby protecting Life from losses due to higher interest rates at the time of surrender. The amount of the lump sum or monthly income payment will not fluctuate due to adverse changes in other components of Life's investment return, mortality experience or expenses. Life's primary fixed MVA annuities have terms varying from one to ten years with an average term to maturity of approximately four years. Account values of fixed MVA annuities were \$9.9 billion, \$10.2 billion and \$11.4 billion as of December 31, 2006, 2005 and 2004, respectively.

Mutual Funds Life launched a family of retail mutual funds for which Life provides investment management and administrative services. The fund family has grown significantly from 8 funds at inception to the current offering of 52 mutual funds and 1 closed end fund, including the addition of 4 new funds in 2006, The Hartford Balanced Income Fund, The Hartford Large Cap Growth Fund, The Hartford Mid Cap Growth Fund and the Hartford Select Small Cap Value Fund. Life's funds are managed by Wellington and HIMCO. Life has entered into agreements with over 1,200 financial services firms to distribute these mutual funds.

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Life charges fees to the shareholders of the mutual funds, which are recorded as revenue by Life. Investors can purchase shares in the mutual funds, all of which are registered with the Securities and Exchange Commission, in accordance with the Investment Company Act of 1940. The mutual funds are owned by the shareholders of those funds and not by Life. As such, the mutual fund assets and liabilities, as well as related investment returns, are not reflected in The Hartford's consolidated financial statements. Total retail mutual fund assets under management were \$38.5 billion, \$29.1 billion, and \$25.2 billion as of December 31, 2006, 2005 and 2004, respectively.

Marketing and Distribution

Life's distribution network is based on management's strategy of utilizing multiple and competing distribution channels to achieve the broadest distribution to reach target customers. The success of Life's marketing and distribution system depends on its product offerings, fund performance, successful utilization of wholesaling organizations, quality of customer service, and relationships with national and regional broker-dealer firms, banks and other financial institutions, and independent financial advisors (through which the sale of Life's retail investment products to customers is consummated).

Life maintains a distribution network of approximately 1,500 broker-dealers and approximately 500 banks. As of December 31, 2006, Life was selling products through the 25 largest retail banks in the United States. Life periodically negotiates provisions and terms of its relationships with unaffiliated parties, and there can be no assurance that such terms will remain acceptable to Life or such third parties. Life's primary wholesaler of its individual annuities is PLANCO Financial Services, LLC and its affiliate, PLANCO, LLC (collectively PLANCO) which are wholly owned subsidiaries of Hartford Life and Accident Insurance Company (HLA). PLANCO is one of the nation's largest wholesalers of individual annuities and has played a significant role in The Hartford's growth over the past decade. As a wholesaler, PLANCO distributes Life's fixed and variable annuities, mutual funds, 529 plans and offshore products by providing sales support to registered representatives, financial planners and broker-dealers at brokerage firms and banks across the United States. Owning PLANCO secures an important distribution channel for Life and gives Life a wholesale distribution platform which it can expand in terms of both the number of individuals wholesaling its products and the portfolio of products which they wholesale.

Competition

Retail competes with numerous other insurance companies as well as certain banks, securities brokerage firms, independent financial advisors and other financial intermediaries marketing annuities, mutual funds and other retirement-oriented products. Product sales are affected by competitive factors such as investment performance ratings, product design, visibility in the marketplace, financial strength ratings, distribution capabilities, levels of charges and credited rates, reputation and customer service.

Retirement Plans

Life is among the top providers of retirement products and services. Products and services offered by Retirement include asset management and plan administration sold to municipalities and not-for-profit organizations pursuant to Section 457 and 403(b) of the Internal Revenue Code of 1986, as amended (referred to as Section 457 and 403(b), respectively). Life also provides retirement products and services, including asset management and plan administration sold to small- and medium-size corporations pursuant to Section 401(k) of the Internal Revenue Code of 1986, as amended (referred to as 401(k)).

Life's total account values related to retirement plans were \$23.6 billion, \$19.3 billion and \$16.5 billion as of December 31, 2006, 2005 and 2004, respectively. Governmental account values were \$11.5 billion, \$10.5 billion and \$10.0 billion as of December 31, 2006, 2005 and 2004, respectively. 401(k) products account values were \$12.0 billion, \$8.8 billion and \$6.5 billion as of December 31, 2006, 2005 and 2004, respectively. Retirement Plans generated revenues of \$538, \$470 and \$434 in 2006, 2005 and 2004, respectively, and net income of \$109, \$75 and \$66 in 2006, 2005 and 2004, respectively.

Principal Products

Governmental Life sells retirement plan products and services to municipalities under Section 457 plans. Life offers a number of different investment products, including variable annuities and fixed products, to the employees in Section 457 plans. Generally, with the variable products, Life manages the fixed income funds and certain other outside money managers act as advisors to the equity funds offered in Section 457 plans administered by Life. As of

December 31, 2006, Life administered over 3,600 plans under Sections 457 and 403(b).

401(k) Life sells retirement plan products and services to corporations under 401(k) plans targeting the small and medium case markets. Life believes these markets are under-penetrated in comparison to the large case market. The number of 401(k) plans administered as of December 31, 2006 was over 12,700. Total assets under management were \$13.2 billion, \$9.8 billion and \$7.3 billion as of December 31, 2006, 2005 and 2004, respectively.

Marketing and Distribution

In the Section 457 market, Retirement Plan s distribution network uses internal personnel with extensive experience to sell its products and services in the retirement plan and institutional markets. The success of Life s marketing and distribution system depends on its

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product offerings, fund performance, successful utilization of wholesaling organizations, quality of customer service, and relationships with national and regional broker-dealer firms, banks and other financial institutions.

In the 401(k) market, Retirement Plan's primary wholesaler of its plans is PLANCO. As a wholesaler, PLANCO distributes Life's 401(k) plans by providing sales support to registered representatives, financial planners and broker-dealers at brokerage firms and banks across the United States. In addition, Life uses internal personnel with extensive experience in the 401(k) market to sell its products and services in the retirement plan market.

Competition

Retirement Plans competes with numerous other insurance companies as well as certain banks, securities brokerage firms, independent financial advisors and other financial intermediaries marketing annuities, mutual funds and other retirement-oriented products. Product sales are affected by competitive factors such as investment performance ratings, product design, visibility in the marketplace, financial strength ratings, distribution capabilities, levels of charges and credited rates, reputation and customer service.

For the Section 457 and 403(b) as well as the 401(k) markets, which offer mutual funds wrapped in a variable annuity or mutual fund retirement program (government markets), the variety of available funds and their performance is most important to plan sponsors. The competitors tend to be the major mutual fund companies.

Institutional

Life provides structured settlement contracts, institutional annuities, longevity assurance, institutional mutual funds and stable value investment products such as funding agreements, funding agreement backed notes, consumer notes, and guaranteed investment contracts (GICs) through the Institutional Investment Products (IIP) business unit. Additionally, Life is a leader in the variable PPLI market, which includes life insurance policies purchased by a company or a trust on the lives of employees, with Life or a trust sponsored by Life named as the beneficiary under the policy.

In 2005, Life introduced two new products for the high net worth markets. One is a specialized life insurance contract for ultra-wealthy, high net worth investors. The other is a hedge fund designed to leverage the strengths of The Hartford's award-winning customer service and distribution capability.

In 2006, Life introduced one new product for the retail market, longevity assurance. Longevity assurance is designed to provide policyholders with the security that they will not outlive their assets in the form of a deferred fixed annuity with life contingencies. Life also changed the legal structure of its retail note platform by directly issuing retail registered notes (consumer notes) to investors. In addition to consumer note offerings, Life issues funding agreements to trusts, which, in turn, issues notes to retail and institutional investors.

Life's total account values related to institutional investment products were \$22.2 billion, \$17.9 billion and \$14.6 billion as of December 31, 2006, 2005 and 2004, respectively. Variable PPLI products account values were \$26.1 billion, \$23.8 billion and \$22.5 billion as of December 31, 2006, 2005 and 2004, respectively. Institutional generated revenues of \$1.7 billion, \$1.4 billion and \$1.3 billion in 2006, 2005 and 2004, respectively and net income of \$99, \$88 and \$68 in 2006, 2005 and 2004, respectively.

Principal Products

Institutional Investment Products Life sells the following institutional investment products: structured settlements, institutional mutual funds, GICs and other short-term funding agreements, and other annuity contracts for special purposes such as funding of terminated defined benefit pension plans (institutional annuities arrangements).

Structured Settlements Structured settlement annuity contracts provide for periodic payments to an injured person or survivor, typically in settlement of a claim under a liability policy in lieu of a lump sum settlement. Contracts pay either life contingent or period certain benefits, which is at the discretion of the contract holder.

Institutional Mutual Funds Life sells institutional shares of The Hartford Mutual Funds (Class Y shares) to both qualified (i.e., section 401(k) and 457 plans) and non-qualified (i.e., endowments and foundations) institutional investors on an investment only basis. Life also sells its Hartford HLS Funds and the Hartford HLS Series II Funds, to qualified retirement plans on an investment only basis. That means that the funds are sold individually, with no recordkeeping services included and not as a part of any bundled retirement program. The Hartford's wholly-owned subsidiary, HL Investment Advisors, LLC, serves as the investment advisor to these funds and contracts with sub-advisors to perform the day-to-day management of the funds. The two primary sub-advisors to the Hartford HLS

Funds are Wellington, of Boston, Massachusetts for most of the equity funds and HIMCO for the fixed income funds. *Stable Value Products* GICs are group annuity contracts issued to sponsors of qualified pension or profit-sharing plans or stable value pooled fund managers. Under these contracts, the client deposits a lump sum with The Hartford for a specified period of time for a

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guaranteed interest rate. At the end of the specified period, the client receives principal plus interest earned. Funding agreements are investment contracts that perform a similar function for non-qualified assets. The Company issues fixed and variable rate funding agreements to Hartford Life Global Funding trusts, that, in turn, issue registered notes to institutional and retail investors. During 2006, the Company began issuing consumer notes directly to retail investors.

Institutional Annuities Institutional annuities arrangements are group annuity contracts used to fund pension liabilities that exist when a qualified retirement plan sponsor decides to terminate an existing defined benefit pension plan. Group annuity contracts are very long-term in nature, since they must pay the pension liabilities typically on a monthly basis to all participants covered under the pension plan which is being terminated.

Longevity assurance Longevity assurance is a fixed deferred-payout annuity that provides life contingent benefits to individuals with the purpose of providing individuals with protection from the risk of outliving retirement income.

Single Premium Immediate Annuities Single premium immediate annuities (SPIA) are individual contracts that provide a fixed immediate payout annuity. Contracts pay either life contingent or period certain benefits, at the discretion of the contract holder.

Variable PPLI Products Private Placement Variable Life Insurance (PPVLI) products continue to be used by employers to fund non-qualified benefits or other post-employment benefit liabilities. A key advantage to plan sponsors is the opportunity to select from a range of tax deferred investment allocations. Recent clarifications in regulatory policy have made PPVLI products particularly attractive to banks with postretirement medical obligations. PPVLI has also been widely used in the high net worth marketplace due to its low costs, range of investment choices and ability to accommodate a fund of funds management style. This institutionally priced hedge fund product is aimed at the rapidly growing market composed of affluent investors unwilling to participate in hedge funds directly due to minimum investment thresholds.

Marketing and Distribution

In the structured settlement market, the Institutional segment sells individual fixed immediate annuity products through a small number of specialty brokerage firms that work closely with The Hartford's Property & Casualty operations. Life also works directly with the brokerage firms on cases that do not involve The Hartford's Property & Casualty operations.

In the institutional mutual fund market, the Institutional segment typically sells its products through investment consulting firms employed by retirement plan sponsors. Institutional's products are also sold through 401(k) record keeping firms that offer a platform of mutual funds to their plan sponsor clients. A third sales channel is direct sales to qualified plan sponsors, using registered representatives employed by Hartford Equity Sales Company, Inc., a subsidiary.

In the stable value marketplace, the Institutional segment sells GICs, funding agreements, and funding agreement backed notes to retirement plan sponsors or other large institutions either through investment management firms or directly, using Hartford employees.

In the institutional annuities market, Life sells its group annuity products to retirement plan sponsors through three different channels: (1) a small number of specialty brokers; (2) large benefits consulting firms; and (3) directly, using Hartford employees.

In the PPVLI market, specialized strategic alliance partners with expertise in the large case market assist in the placement of many cases. High net worth PPVLI is often placed with the assistance of investment banking and wealth management specialists.

The hedge fund of funds product is positioned to be sold through family offices, wealth management platforms and other specialists in the mass-affluent market.

The Institutional segment also distributes consumer notes through a purchasing agent and its corresponding selling group of broker-dealers and securities firms.

Competition

The Institutional segment competes with numerous other insurance companies as well as certain banks, securities brokerage firms, independent financial advisors and other financial intermediaries marketing annuities, mutual funds and other retirement-oriented products. Product sales are affected by competitive factors such as investment

performance ratings, product design, visibility in the marketplace, financial strength ratings, distribution capabilities, levels of charges and credited rates, reputation and customer service.

For institutional product lines offering fixed annuity products (e.g., institutional annuities, structured settlements, SPIAs, longevity assurance and stable value), financial strength, stability and credit ratings are key buying factors. As a result, the competitors in those marketplaces tend to be other large, long-established insurance companies.

For product lines offering mutual funds either unbundled (institutional mutual funds) or wrapped in a variable annuity or mutual fund retirement program (government markets) the variety of available funds and their performance is most important to plan sponsors. The competitors tend to be the major mutual fund companies.

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For PPVLI, competition in the large case market comes from other insurance carriers and from specialized agents with expertise in the benefit funding marketplace. For high net worth programs, the competition is often from other investment banking firms allied with other insurance carriers.

Individual Life

The Individual Life segment provides life insurance strategies to a wide array of business intermediaries and partners to solve the wealth protection, accumulation and transfer needs of its affluent, emerging affluent and business life insurance clients. As of December 31, 2006, life insurance in force increased 9% to \$164.2 billion, from \$150.8 billion and \$139.9 billion as of December 31, 2005 and 2004, respectively. Account values increased 11% to \$11.4 billion as of December 31, 2006 from \$10.3 billion and \$9.5 billion as of December 31, 2005 and 2004, respectively. Revenues were \$1.2 billion, \$1.1 billion and \$1.1 billion in 2006, 2005 and 2004, respectively. Net income in Individual Life was \$170, \$166 and \$155 in 2006, 2005 and 2004, respectively.

Principal Products

Life holds a significant market share in the variable universal life product market and is a leading seller of variable universal life insurance according to the Tillinghast VALUE Survey as of September 30, 2006. Sales in the Individual Life segment were \$284, \$250 and \$233 in 2006, 2005 and 2004, respectively.

Variable Universal Life Variable universal life provides life insurance with an investment return linked to underlying investments as policyholders are allowed to invest premium dollars among a variety of underlying mutual funds. As the return on the investment portfolios increase or decrease, the surrender value of the variable universal life policy will increase or decrease, and, under certain policyholder options or market conditions, the death benefit may also increase or decrease. Life's second-to-die products are distinguished from other products in that two lives are insured rather than one, and the policy proceeds are paid upon the deaths of both insureds. Second-to-die policies are frequently used in estate planning for a married couple as the policy proceeds are paid out at the time an estate tax liability is incurred. Variable universal life account values were \$6.6 billion, \$5.9 billion and \$5.4 billion as of December 31, 2006, 2005 and 2004, respectively.

Universal Life and Interest Sensitive Whole Life Universal life and interest sensitive whole life insurance coverages provide life insurance with adjustable rates of return based on current interest rates and on the returns of the underlying investment portfolios. Universal life provides policyholders with flexibility in the timing and amount of premium payments and the amount of the death benefit, provided there are sufficient policy funds to cover all policy charges for the coming period, unless guaranteed no-lapse coverage is in effect. At December 31, 2006 and 2005, guaranteed no-lapse universal life represented approximately 6% and 4% of life insurance in-force, respectively. Life also sells second-to-die universal life insurance policies.

Marketing and Distribution

Consistent with Life's strategy to access multiple distribution outlets, the Individual Life distribution organization has been developed to penetrate multiple retail sales channels. Life sells both variable and fixed individual life products through a wide distribution network of national and regional broker-dealer organizations, banks and independent financial advisors. Life is a market leader in selling individual life insurance through national stockbroker and financial institutions channels. In addition, Life distributes individual life products through independent life and property-casualty agents and Woodbury Financial Services, a subsidiary retail broker-dealer. To wholesale Life's products, Life has a group of highly qualified life insurance professionals with specialized training in sophisticated life insurance sales. These individuals are generally employees of Life who are managed through a regional sales office system.

Competition

Individual Life competes with approximately 1,100 life insurance companies in the United States, as well as other financial intermediaries marketing insurance products. Competitive factors related to this segment are primarily the breadth and quality of life insurance products offered, pricing, relationships with third-party distributors, effectiveness of wholesaling support, pricing and availability of reinsurance, and the quality of underwriting and customer service.

Group Benefits

The Group Benefits segment provides employers, associations, affinity groups and financial institutions with group life, accident and disability coverage, along with other products and services, including voluntary benefits, group

retiree health, and medical stop loss. Life ranks number two in fully-insured group disability premium and number four in fully-insured life premium of U.S. group carriers (according to LIMRA data as of June 30, 2006). The Company also offers disability underwriting, administration, claims processing services and reinsurance to other insurers and self-funded employer plans. Generally, policies sold in this segment are term insurance. This allows the Company to adjust the rates or terms of its policies in order to minimize the adverse effect of various market trends, including declining interest rates and other factors. Typically policies are sold with one-, two- or three-year rate guarantees depending upon the product. In the disability market, the Company focuses on its risk management expertise and on efficiencies and economies of scale to derive a competitive advantage. Group Benefits generated fully insured ongoing premiums of \$4.1 billion, \$3.7 billion and \$3.6

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billion in 2006, 2005 and 2004, respectively, of which group disability insurance accounted for \$1.8 billion, \$1.7 billion and \$1.6 billion in 2006, 2005 and 2004, respectively, and group life insurance accounted for \$1.8 billion, \$1.6 billion and \$1.7 billion for the year ended December 31, 2006, 2005 and 2004, respectively. The Company held group disability reserves of \$4.5 billion, \$4.4 billion and \$4.2 billion and group life reserves of \$1.3 billion, \$1.3 billion and \$1.2 billion, as of December 31, 2006, 2005 and 2004, respectively. Net income in Group Benefits was \$303, \$272 and \$229 in 2006, 2005 and 2004, respectively.

Principal Products

Group Disability Life is one of the largest carriers in the large case market of the group disability insurance business. Life's strong market presence in the group disability markets is the result of its well known brand recognition and reputation, financial strength and stability and Life's approach to claims management. Life also offers voluntary, or employee-paid, short-term and long-term disability group benefits. Life's efforts in the group disability market focus on early intervention, return-to-work programs and successful rehabilitation, offering the support to help claimants return to an active, productive life after a disability. Life also works with disability claimants to improve their approval rate for Social Security Assistance (i.e., reducing payment of benefits by the amount of Social Security payments received).

Life's short-term disability benefit plans provide a weekly benefit amount (typically 60% to 70% of the insured's earned income up to a specified maximum benefit) to insureds when they are unable to work due to an accident or illness. Long-term disability insurance provides a monthly benefit for those extended periods of time not covered by a short-term disability benefit plan when insureds are unable to work due to disability. Insureds may receive total or partial disability benefits. Most of these policies begin providing benefits following a 90- or 180-day waiting period and generally continue providing benefits until the insured reaches age 65. Long-term disability benefits are paid monthly and are limited to a portion, generally 50-70%, of the insured's earned income up to a specified maximum benefit.

Group Life and Accident Group term life insurance provides term coverage to employees and members of associations, affinity groups and financial institutions and their dependents for a specified period and has no accumulation of cash values. Life offers options for its basic group life insurance coverage, including portability of coverage and a living benefit and critical illness option, whereby terminally ill policyholders can receive death benefits in advance. Life also offers voluntary, or employee-paid, life group benefits and accidental death and dismemberment coverage either packaged with life insurance or on a stand-alone basis.

Other Life offers a host of other products and services, such as Family and Medical Leave Act Administration, group retiree health, and specialized insurance products for physicians. Life provides excess of loss medical coverage (known as stop loss insurance) to employers who self-fund their medical plans and pay claims using the services of a third party administrator. Life also provides travel accident, hospital indemnity, supplemental health insurance for military personnel and their families and other coverages to individual members of various associations, affinity groups, financial institutions and employee groups.

Marketing and Distribution

Life uses an experienced group of Company employees, managed through a regional sales office system, to distribute its group insurance products and services through a variety of distribution outlets, including brokers, consultants, third-party administrators and trade associations.

Competition

The Group Benefits business remains highly competitive. Competitive factors primarily affecting Group Benefits are the variety and quality of products and services offered, the price quoted for coverage and services, Life's relationships with its third-party distributors, and the quality of customer service. Group Benefits competes with numerous other insurance companies and other financial intermediaries marketing insurance products. However, many of these businesses have relatively high barriers to entry and there have been few new entrants into the group benefits insurance market over the past few years.

International

International, which has operations located in Japan, Brazil, Ireland and the United Kingdom, provides investments, retirement savings and other insurance and savings products to individuals and groups outside the United States and

Canada. International revenues were \$759, \$524 and \$250 in 2006, 2005 and 2004, respectively. Net income for International was \$246, \$96 and \$39 in 2006, 2005 and 2004, respectively. International's total assets under management were \$33.9 billion, \$27.8 billion and \$16.1 billion as of December 31, 2006, 2005 and 2004, respectively. The Company's Japan operation, Hartford Life Insurance K.K. (HLIKK), which began selling variable annuities in December 2000, has continued to grow significantly and remains the largest distributor of variable annuities in Japan, based on assets under management. In August 2004, the Company began selling yen and U.S. dollar denominated fixed annuities in Japan. With assets under management of \$31.3 billion, \$26.1 billion and \$14.6 billion as of December 31, 2006, 2005 and 2004, respectively, the Japan operation is the largest component of International with net income of \$267, \$120 and \$36 in 2006, 2005 and 2004, respectively. The Company's Japan operation sells both variable and fixed individual annuity products through a wide distribution network of Japan's broker-dealer organizations, banks and other financial institutions and independent financial advisors. The Company is one of the largest

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sellers of individual retail variable annuities in Japan with sales of \$5.8 billion, \$10.7 billion and \$7.3 billion in 2006, 2005 and 2004, respectively.

International's other operations include a 50% owned joint venture in Brazil and a startup operation in Europe. The Brazil joint venture operates under the name Icatu-Hartford and distributes pension, life insurance and other insurance and savings products through broker-dealer organizations and various partnerships. The Company's European operation, Hartford Life Limited, began selling unit-linked investment bonds in the United Kingdom in April 2005. Unit-linked bonds are similar to variable annuities marketed in the United States and Japan. Hartford Life Limited established its operations in Dublin, Ireland with a branch office in London to help market and service its business in the United Kingdom.

Principal Products

Individual Variable Annuities The Company earns fees, based on policyholders' account values, for managing variable annuity assets and maintaining policyholder accounts. The Company uses specified portions of the periodic deposits paid by a customer to purchase units in one or more mutual funds as directed by the customer, who then assumes the investment performance risks and rewards. These products offer the policyholder a variety of equity and fixed income options. Additionally, International sells variable annuity contracts that offer various guaranteed minimum death, investment, and living benefits.

Policyholders may make deposits of varying amounts at regular or irregular intervals, and the value of these assets fluctuates in accordance with the investment performance of the funds selected by the policyholder. To encourage persistency, many of the Company's individual variable annuities are subject to withdrawal restrictions and surrender charges. Surrender charges range up to 7% of the contract's deposits, less withdrawals, and reduce to zero on a sliding scale, usually within seven years from the deposit date. In Japan, individual variable annuity account values of \$29.7 billion, as of December 31, 2006, have grown from \$24.6 billion, as of December 31, 2005, and \$14.1 billion, as of December 31, 2004.

Fixed MVA Annuities Fixed MVA annuities are fixed rate annuity contracts that guarantee a specific sum of money to be paid in the future, either as a lump sum or as monthly income. In the event that a policyholder surrenders a policy prior to the end of the guarantee period, the MVA feature adjusts the contract's cash surrender value with respect to any changes in interest rates, thereby protecting the Company from losses due to higher interest rates at the time of surrender. The amount of lump sum or monthly income payments will not fluctuate due to adverse changes in the Company's investment return, mortality experience or expenses. The Company's primary fixed MVA annuities in Japan are yen and dollar denominated with terms varying from five to ten years with an average term to maturity of approximately seven years. In Japan, account values of fixed MVA annuities were \$1.7 billion, \$1.5 billion and \$502 as of December 31, 2006, 2005 and 2004, respectively.

Marketing and Distribution

The International distribution network is based on management's strategy of developing and utilizing multiple and competing distribution channels to achieve the broadest distribution to reach target customers. The success of the Company's marketing and distribution system depends on its product offerings, fund performance, successful utilization of wholesaling, quality of customer service, and relationships with securities firms, banks and other financial institutions, and independent financial advisors (through which the sale of the Company's retail investment products to customers is consummated). As of December 31, 2006, the Japan operation employed a wholesaling network that supports sales through 56 banks and securities firms.

Competition

The International segment competes with a number of domestic and international insurance companies in Japan. Product sales are affected by competitive factors such as investment performance ratings, product design, visibility in the marketplace, financial strength ratings, distribution capabilities, levels of charges and credited rates, reputation and customer service. Competition has continued to increase in the Japanese market with the most significant competition the result of the strengthening of domestic competitors. This competition has resulted in changes in key distribution relationships. The Company continues to focus efforts on strengthening distribution relationships and improving wholesaling and servicing efforts.

Property & Casualty

Property & Casualty provides (1) workers compensation, property, automobile, liability, umbrella, specialty casualty, marine, livestock and fidelity and surety coverages to commercial accounts primarily throughout the United States; (2) professional liability coverage and directors and officers liability coverage, as well as excess and surplus lines business not normally written by standard commercial lines insurers; (3) automobile, homeowners and home-based business coverage to individuals throughout the United States; and (4) insurance-related services.

The Hartford seeks to distinguish itself in the property and casualty market through its product depth and innovation, distribution capacity, customer service expertise, and technology for ease of doing business. The Hartford is the eleventh largest property and casualty insurance operation in the United States based on direct written premiums for the year ended December 31, 2005, according to

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A.M. Best Company, Inc. (A.M. Best). Property & Casualty generated revenues of \$12.4 billion, \$12.0 billion and \$11.3 billion in 2006, 2005 and 2004, respectively. Revenues include earned premiums, servicing revenue, net investment income and net realized capital gains and losses. Earned premiums for 2006, 2005 and 2004 were \$10.4 billion, \$10.2 billion and \$9.5 billion, respectively. Additionally, net income was \$1.5 billion, \$1.2 billion and \$910 for 2006, 2005 and 2004, respectively. Total assets for Property & Casualty were \$41.0 billion, \$40.3 billion and \$38.0 billion as of December 31, 2006, 2005 and 2004, respectively.

Business Insurance

Business Insurance provides standard commercial insurance coverage to small and middle market commercial businesses primarily throughout the United States. Small commercial businesses generally represent companies with up to \$15 in annual revenues or total property values. Middle market businesses generally represent companies with greater than \$15 in annual revenues or total property values. This segment also provides commercial risk management products and services as well as marine coverage. Earned premiums for 2006, 2005 and 2004 were \$5.1 billion, \$4.8 billion and \$4.3 billion, respectively. The segment had underwriting income of \$618, \$396 and \$360 in 2006, 2005 and 2004, respectively.

Principal Products

Business Insurance offers workers compensation, property, automobile, liability, umbrella and marine coverages under several different products. Some of these coverages are sold together as part of a single package policy for small business owners. Among the products sold within small commercial, the Company offers the Select Xpand product, which is designed to meet the needs of businesses with \$5 to \$15 in revenues. Workers compensation insurance accounts for the largest share of the written premium in the Business Insurance segment. Commercial risk management products and services are also provided.

Marketing and Distribution

Business Insurance provides insurance products and services through its home office located in Hartford, Connecticut, and multiple domestic regional office locations and insurance centers. The segment markets its products nationwide utilizing brokers and independent agents and involving trade associations and employee groups. Brokers and independent agents are not employees of The Hartford.

Competition

The commercial insurance industry is a highly competitive environment regarding product, price, service and technology. The Hartford competes against a number of large, national carriers as well as regional competitors in certain territories. Competitors include other stock companies, mutual companies, alternative risk sharing groups and other underwriting organizations. These companies sell through various distribution channels and business models, across a broad array of product lines, and with a high level of variation regarding geographic, marketing and customer segmentation.

The market for small commercial business has become more competitive as favorable loss costs in the past couple of years have led carriers to expand coverage while maintaining relatively flat pricing. While written premium growth rates in small commercial have been slowing, underwriting margins have been strong driven, in part, by favorable claim frequency. Within the small commercial segment of the business, a number of companies have sought to grow their business by increasing their underwriting appetite and paying more commissions. In addition, a number of companies, like The Hartford, are pursuing agency appointment strategies to increase premium writings. The increase in exposure to catastrophe losses in many coastal areas have led a number of carriers to be more aggressive in pursuing business in the Mid-West where exposure to catastrophes is not as severe.

Middle market business is characterized as high touch with case-by-case underwriting and pricing decisions. As such, compared to small commercial, the pricing of middle market accounts is prone to more significant variation or cyclicity from year to year. Legislative reforms in a number of states in recent years has helped to control indemnity costs on workers compensation claims, but this has also led to downward pressure on rates. In a market of declining or softening prices, carriers are competing to protect their profitable renewals. New business opportunities increasingly involve more complex exposures and risk classes. In addition, there continue to be constraints on the amount of catastrophe capacity available in the marketplace.

The Hartford is the fifth largest commercial lines insurer in the United States based on direct written premiums for the year ended December 31, 2005 according to A.M. Best. The relatively large size and underwriting capacity of The Hartford provide opportunities not available to smaller companies. In addition, the marketplace is affected by available capacity of the insurance industry as measured by statutory surplus. Surplus expands and contracts primarily in conjunction with profit levels generated by the industry. National carriers continue to compete for the same business, while regional carriers are broadening their target market and distribution. Many carriers are focusing on technology to streamline the underwriting process, provide more efficient customer service, introduce more sophisticated pricing models and increase the volume of business sold through agents.

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Personal Lines

Personal Lines provides automobile, homeowners and home-based business coverages to the members of AARP through a direct marketing operation; to individuals who prefer local agent involvement through a network of independent agents in the standard personal lines market. Up until the sale of the business on November 30, 2006, the Company also sold non-standard auto insurance through the Company's Omni Insurance Group, Inc. (Omni) subsidiary. The Hartford's exclusive licensing arrangement with AARP continues until January 1, 2020 for automobile, homeowners and home-based business. This agreement provides Personal Lines with an important competitive advantage. Personal Lines also operates a member contact center for health insurance products offered through AARP's Health Care Options. The Health Care Options agreement continues through 2009. Personal Lines had earned premiums of \$3.8 billion, \$3.6 billion and \$3.4 billion in 2006, 2005 and 2004, respectively. Underwriting income for 2006, 2005 and 2004 was \$429, \$460 and \$138, respectively. AARP had earned premiums of \$2.5 billion, \$2.3 billion and \$2.1 billion in 2006, 2005 and 2004, respectively.

Principal Products

Personal Lines provides standard and non-standard automobile, homeowners and home-based business coverages to individuals across the United States, including a special program designed exclusively for members of AARP. During 2006, the Company enhanced its new Dimensions automobile and homeowners class plans for insurance sold through independent agents and brokers. Dimensions with Packages, introduced in 2006, is a suite of products that offers coverages and competitive rates tailored to a customer's individual risk. Dimensions uses a large number of interactive rating variables to determine a rate that most accurately reflects the customer's individual characteristics.

Marketing and Distribution

Personal Lines reaches diverse markets through multiple distribution channels including brokers, independent agents, direct marketing, the internet and advertising in publications. This segment provides customized products and services to customers through a network of independent agents in the standard personal lines market. Brokers and independent agents are not employees of The Hartford. Personal Lines has an important relationship with AARP and markets directly to its nearly 38 million members.

Competition

The personal lines automobile and homeowners businesses are highly competitive. Personal lines insurance is written by insurance companies of varying sizes that sell products through various distribution channels, including independent agents, captive agents and directly to the consumer. The personal lines market competes on the basis of price; product; service, including claims handling; stability of the insurer and name recognition. A number of carriers will likely continue to increase their advertising in an effort to gain new business and retain profitable business. In addition, carriers that distribute products mainly through agents are offering additional incentives to those agents to attract new business. To distinguish themselves in the marketplace, top tier carriers are offering on-line and self service capabilities to agents and consumers. In addition, the capability to sell direct to the consumer has become increasingly important as a greater number of consumers use the internet to research or shop for auto insurance. Through information technology, carriers will likely further segment their pricing plans to expand market share in what they believe to be the most profitable segments. Carriers with more efficient cost structures will have an advantage in competing for new business through price. Some competitors are introducing new products at substantially reduced rate levels and the Company expects that top tier carriers will continue to capture a larger share of industry revenues and profits.

The Hartford is the twelfth largest personal lines insurer in the United States based on direct written premiums for the year ended December 31, 2005 according to A.M. Best. A major competitive advantage of The Hartford is the exclusive licensing arrangement with AARP to provide personal automobile, homeowners and home-based business insurance products to its members. This arrangement is in effect until January 1, 2020. Management expects favorable baby boom demographics to increase AARP membership during this period.

Specialty Commercial

Specialty Commercial provides a wide variety of property and casualty insurance products and services through retailers and wholesalers to large commercial clients and insureds requiring a variety of specialized coverages. Excess and surplus lines coverages not normally written by standard line insurers are also provided, primarily through

wholesale brokers. Specialty Commercial had earned premiums of \$1.6 billion, \$1.8 billion and \$1.7 billion in 2006, 2005 and 2004, respectively. Underwriting income (loss) was \$64, (\$165) and (\$53) in 2006, 2005 and 2004, respectively.

Principal Products

Specialty Commercial offers a variety of customized insurance products and risk management services. Specialty Commercial provides standard commercial insurance products including workers' compensation, automobile and liability coverages to large-sized companies. Specialty Commercial also provides bond, professional liability, specialty casualty and livestock coverages, as well as core property and

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excess and surplus lines coverages not normally written by standard lines insurers. A significant portion of specialty casualty business, including workers' compensation business, is written through large deductible programs where the insured typically provides collateral to support loss payments made within their deductible. Specialty Casualty also provides retrospectively-rated programs where the premiums are adjustable based on loss experience. Alternative markets, within Specialty Commercial, provides insurance products and services primarily to captive insurance companies, pools and self-insurance groups. In addition, Specialty Commercial provides third-party administrator services for claims administration, integrated benefits, loss control and performance measurement through Specialty Risk Services, LLC, a subsidiary of the Company.

Marketing and Distribution

Specialty Commercial provides insurance products and services through its home office located in Hartford, Connecticut and multiple domestic office locations. The segment markets its products nationwide utilizing a variety of distribution networks including independent agents and brokers as well as wholesalers. Brokers, independent agents and wholesalers are not employees of The Hartford.

Competition

The commercial insurance industry is a highly competitive environment regarding product, price and service. Specialty Commercial is comprised of a diverse group of businesses that are unique to commercial lines. Each line of business operates independently with its own set of business objectives, and focuses on the operational dynamics of their specific industry. These businesses, while somewhat interrelated, have a unique business model and operating cycle. Specialty Commercial is considered a transactional business and, therefore, competes with other companies for business primarily on an account by account basis due to the complex nature of each transaction. On specialty casualty business, written pricing competition is expected to be significant. With national account business, carriers will likely offer more lower-deductible policies and guaranteed cost policies. The Company expects competition among national carriers to continue to be very strong and larger regional carriers will likely target specific accounts at renewal. Within professional liability, in 2005 and 2006 there was a decrease in the number of securities class actions suits and this has put some downward pressure on rates. While pricing for specialty property increased significantly during 2006 as higher reinsurance costs were passed on to insureds, pricing increases will likely be less significant in 2007. Carriers continue to manage their aggregate exposure to property losses in catastrophe-prone areas.

Earned premium growth is not an objective of Specialty Commercial since premium writings may fluctuate based on the segment's view of perceived market opportunity. Specialty Commercial competes with other stock companies, mutual companies, alternative risk sharing groups and other underwriting organizations. The relatively large size and underwriting capacity of The Hartford provide opportunities not available to smaller companies.

Other Operations

The Other Operations segment includes operations that are under a single management structure, Heritage Holdings, which is responsible for two related activities. The first activity is the management of certain subsidiaries and operations of The Hartford that have discontinued writing new business. The second is the management of claims (and the associated reserves) related to asbestos, environmental and other exposures.

Life Reserves

Life insurance subsidiaries of the Company establish and carry as liabilities, predominantly, three types of reserves: (1) a liability equal to the balance that accrues to the benefit of the policyholder as of the financial statement date, otherwise known as the account value, (2) a liability for unpaid losses, including those that have been incurred but not yet reported, and (3) a liability for future policy benefits, representing the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. The liabilities for unpaid losses and future policy benefits are calculated based on actuarially recognized methods using morbidity and mortality tables, which are modified to reflect Life's actual experience when appropriate. Liabilities for unpaid losses include estimates of amounts to fully settle known reported claims as well as claims related to insured events that the Company estimates have been incurred but have not yet been reported. Future policy benefit reserves are computed at amounts that, with additions from estimated net premiums to be received and with interest on such reserves compounded annually at certain assumed rates, are expected to be sufficient to meet Life's policy obligations at their maturities or in the event

of an insured's disability or death. Other insurance liabilities include those for unearned premiums and benefits in excess of account value. Reserves for assumed reinsurance are computed in a manner that is comparable to direct insurance reserves.

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Property & Casualty Reserves

The Hartford establishes property and casualty reserves to provide for the estimated costs of paying claims under insurance policies written by The Hartford. These reserves include estimates for both claims that have been reported and those that have been incurred but not reported to The Hartford and include estimates of all expenses associated with processing and settling these claims. This estimation process involves a variety of actuarial techniques and is primarily based on historical experience and consideration of current trends. Examples of current trends include increases in medical cost inflation rates, the changing use of medical care procedures, the introduction of new products such as the Dimensions for auto product in Personal Lines, changes in internal claim practices, changes in the legislative and regulatory environment over workers' compensation claims, evolving exposures to claims asserted against religious institutions and other organizations relating to molestation or abuse and other mass torts.

The Hartford continues to receive claims that assert damages from asbestos-related and environmental-related exposures. Asbestos claims relate primarily to bodily injuries asserted by those who came in contact with asbestos or products containing asbestos. Environmental claims relate primarily to pollution related clean-up costs. As discussed further in the Critical Accounting Estimates and Other Operations sections of the MD&A, significant uncertainty limits the Company's ability to estimate the ultimate reserves necessary for unpaid losses and related expenses with regard to environmental and particularly asbestos claims.

Most of the Company's property and casualty reserves are not discounted. However, certain liabilities for unpaid losses for permanently disabled claimants have been discounted to present value using an average interest rate of 5.6% in 2006 and 2005. As of December 31, 2006 and 2005, such discounted reserves totaled \$707 and \$680, respectively (net of discounts of \$510 and \$505, respectively). In addition, certain structured settlement contracts that fund loss run-offs for unrelated parties having payment patterns that are fixed and determinable have been discounted to present value using an average interest rate of 5.5%. At December 31, 2006 and 2005, such discounted reserves totaled \$273 and \$264, respectively (net of discounts of \$95 and \$103, respectively). Accretion of these discounts was \$32, \$30, and \$29 in 2006, 2005 and 2004, respectively.

As of December 31, 2006, net property and casualty reserves for losses and loss adjustment expenses reported under Generally Accepted Accounting Principles (GAAP) exceeded net reserves reported on a statutory basis by \$29. The difference primarily results from a portion of the GAAP provision for uncollectible reinsurance not recognized under statutory accounting and the required exclusion from statutory reserves of assumed retroactive reinsurance, largely offset by the discounting of GAAP-basis workers' compensation reserves at rates no higher than risk-free interest rates; such rates generally exceed the statutory discount rates set by regulators.

Further discussion on The Hartford's property and casualty reserves, including asbestos and environmental claims reserves, may be found in the Reserves section of the MD&A Critical Accounting Estimates.

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A reconciliation of liabilities for unpaid losses and loss adjustment expenses is herein referenced from Note 11 of Notes to Consolidated Financial Statements. A table depicting the historical development of the liabilities for unpaid losses and loss adjustment expenses, net of reinsurance, follows.

Loss Development Table

Property And Casualty Loss And Loss Adjustment Expense Liability Development Net of Reinsurance
For the years ended December 31, [1]

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
--	------	------	------	------	------	------	------	------	------	------	------

Liabilities for
unpaid losses
and loss
adjustment
expenses, net
of reinsurance

	\$ 12,702	\$ 12,770	\$ 12,902	\$ 12,476	\$ 12,316	\$ 12,860	\$ 13,141	\$ 16,218	\$ 16,191	\$ 16,863	\$ 17,604
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**Cumulative paid losses and loss
expenses**

One year later	2,625	2,472	2,939	2,994	3,272	3,339	3,480	4,415	3,594	3,702	
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Two years later	4,188	4,300	4,733	5,019	5,315	5,621	6,781	6,779	6,035		
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Three years later	5,540	5,494	6,153	6,437	6,972	8,324	8,591	8,686			
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Four years later	6,418	6,508	7,141	7,652	9,195	9,710	10,061				
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Five years later	7,201	7,249	8,080	9,567	10,227	10,871					
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Six years later	7,800	8,036	9,818	10,376	11,140						
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Seven years later	8,499	9,655	10,501	11,137							
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Eight years later	10,044	10,239	11,246								
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Nine years later	10,576	10,933									
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Ten years later	11,237										
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Liabilities

re-estimated

One year later	12,752	12,615	12,662	12,472	12,459	13,153	15,965	16,632	16,439	17,159	
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Two years later	12,653	12,318	12,569	12,527	12,776	16,176	16,501	17,232	16,838		
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Three years later	12,460	12,183	12,584	12,698	15,760	16,768	17,338	17,739			
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Four years later	12,380	12,138	12,663	15,609	16,584	17,425	17,876				
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Five years later	12,317	12,179	15,542	16,256	17,048	17,927					
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Six years later	12,322	15,047	16,076	16,568	17,512						
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Seven years later	15,188	15,499	16,290	17,031							
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Eight years later	15,594	15,641	16,799								
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Nine years later	15,713	16,165									
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Ten years later	16,244										
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**Deficiency
(redundancy),
net of
reinsurance**

	\$ 3,542	\$ 3,395	\$ 3,897	\$ 4,555	\$ 5,196	\$ 5,067	\$ 4,735	\$ 1,521	\$ 647	\$ 296	
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[1] The above table excludes Hartford Insurance, Singapore as a result of its sale in September 2001, Hartford Seguros as a result of its sale in February 2001, Zwolsche as a result of its sale in December 2000 and London & Edinburgh as a result of its sale in November 1998.

The table above shows the cumulative deficiency (redundancy) of the Company's reserves, net of reinsurance, as now estimated with the benefit of additional information. Those amounts are comprised of changes in estimates of gross losses and changes in estimates of related reinsurance recoveries.

The table below, for the periods presented, reconciles the net reserves to the gross reserves, as initially estimated and recorded, and as currently estimated and recorded, and computes the cumulative deficiency (redundancy) of the Company's reserves before reinsurance.

Property And Casualty Loss And Loss Adjustment Expense Liability Development										Gross
For the years ended December 31, [1]										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Net reserve, as initially estimated	\$12,770	\$12,902	\$12,476	\$12,316	\$12,860	\$13,141	\$16,218	\$16,191	\$16,863	\$17,604
Reinsurance and other recoverables, as initially estimated	3,996	3,275	3,706	3,871	4,176	3,950	5,497	5,138	5,403	4,387
Gross reserve, as initially estimated	\$16,766	\$16,177	\$16,182	\$16,187	\$17,036	\$17,091	\$21,715	\$21,329	\$22,266	\$21,991
Net reestimated reserve	\$16,165	\$16,799	\$17,031	\$17,512	\$17,927	\$17,876	\$17,739	\$16,838	\$17,159	
	5,051	4,552	5,465	5,502	5,684	5,052	4,964	4,906	5,417	

Reestimated
and other
reinsurance
recoverables

**Gross
reestimated
reserve**

\$21,216 \$21,351 \$22,496 \$23,014 \$23,611 \$22,928 \$22,703 \$21,744 \$22,576

**Gross
deficiency**

(redundancy) \$ 4,450 \$ 5,174 \$ 6,314 \$ 6,827 \$ 6,575 \$ 5,837 \$ 988 \$ 415 \$ 310

*[1] The above table
excludes
Hartford
Insurance,
Singapore as a
result of its sale
in September
2001, Hartford
Seguros as a
result of its sale
in
February 2001,
Zwolsche as a
result of its sale
in
December 2000
and London &
Edinburgh as a
result of its sale
in
November 1998.*

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The following table is derived from the Loss Development table and summarizes the effect of reserve re-estimates, net of reinsurance, on calendar year operations for the ten-year period ended December 31, 2006. The total of each column details the amount of reserve re-estimates made in the indicated calendar year and shows the accident years to which the re-estimates are applicable. The amounts in the total accident year column on the far right represent the cumulative reserve re-estimates during the ten year period ended December 31, 2006 for the indicated accident year(s).

Effect of Net Reserve Re-estimates on Calendar Year Operations

	Calendar Year										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Total
By											
Accident											
year											
1996 &											
Prior	\$50	\$ (99)	\$ (193)	\$ (80)	\$ (63)	\$ 5	\$2,866	\$ 406	\$ 119	\$ 531	\$3,542
1997		(56)	(104)	(55)	18	36	2	46	23	(7)	(97)
1998			57	42	60	38	11	82	72	(15)	347
1999				89	40	92	32	113	98	(46)	418
2000					88	146	73	177	152	1	637
2001						(24)	39	(232)	193	38	14
2002							(199)	(56)	180	36	(39)
2003								(122)	(237)	(31)	(390)
2004									(352)	(108)	(460)
2005										(103)	(103)
Total	\$50	\$ (155)	\$ (240)	\$ (4)	\$143	\$293	\$2,824	\$ 414	\$ 248	\$ 296	\$3,869

The largest impacts of net reserve re-estimates are shown in the 1996 & Prior accident years. The reserve re-estimates in calendar year 2003 include an increase in reserves of \$2.6 billion related to reserve strengthening based on the Company's evaluation of its asbestos reserves. The reserve evaluation that led to the strengthening in calendar year 2003 confirmed the Company's view of the existence of a substantial long-term deterioration in the asbestos litigation environment. The reserve re-estimates in calendar years 2004 and 2006 were largely attributable to reductions in the reinsurance recoverable asset associated with older, long-term casualty liabilities. Excluding the impacts of asbestos and environmental strengthening, over the past ten years, reserve re-estimates for total Property & Casualty ranged from (3.0%) to 1.6% of total net recorded reserves.

Reserves for accident year 1997 show the effects of favorable reestimation in subsequent years. A contributing factor to this improvement, spread over several calendar years, was an unexpected improvement in the environment for workers' compensation. With the benefit of hindsight, annual changes in loss cost trends were very low during this period as compared to historical experience. Because it took several years for this improvement to emerge in the data, it similarly took several years for this to be recognized in the Company's estimates of liabilities.

Until calendar year 2006, there was also reserve deterioration, spread over several calendar years, on accident years 1998-2000. Assumed casualty reinsurance contributed in part to this deterioration. Numerous actuarial assumptions on assumed casualty reinsurance turned out to be low, including loss cost trends, particularly on excess of loss business, and the impact of deteriorating terms and conditions. Workers' compensation also contributed to this deterioration, as medical inflation trends were above initial expectations.

Accident years 2001 and 2002 are reasonably close to original estimates. However, each year shows some swings by calendar period, with some favorable development later offset by unfavorable development. The release for accident year 2001 during calendar year 2004 relates primarily to reserves for September 11. Subsequent adverse developments

on accident year 2001 relate to assumed casualty reinsurance and unexpected development on mature claims in both general liability and workers' compensation. Reserve releases for accident year 2002 during calendar years 2003 and 2004 come largely from short-tail lines of business, where results emerge quickly and actual reported losses are predictive of ultimate losses. Reserve increases on accident year 2002 during calendar year 2005 were recognized, as unfavorable development on accident years prior to 2002 caused the Company to increase its estimate of unpaid losses for the 2002 accident year. Further increases occurred in 2006 due to unexpected development in general liability and workers' compensation losses.

Accident years 2003 through 2005 show favorable development in calendar years 2004 through 2006. A portion of the release comes from short-tail lines of business, where results emerge quickly. During calendar year 2005 and 2006, favorable re-estimates occurred in Personal Lines for both loss and allocated loss adjustment expenses. Workers' compensation also experienced favorable re-estimates of both loss and allocated loss adjustment expenses as the latest evaluations of workers' compensation claims indicate that expense reduction initiatives and reform in states such as California have had a greater impact in controlling costs than was originally estimated. In addition, catastrophe reserves related to the 2004 and 2005 hurricanes developed favorably in 2006.

Within professional liability business, during calendar year 2005, reserves were released for directors and officers insurance on accident years 2003 and 2004 due to favorable developments, while prior accident year reserves were strengthened for contracts that provide auto

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financing gap coverage and auto lease residual value coverage. In 2003, the Company stopped writing contracts that provide auto financing gap coverage and auto lease residual value coverage.

Ceded Reinsurance

Consistent with industry practice, The Hartford cedes insurance risk to reinsurance companies. Reinsurance does not relieve The Hartford of its primary liability and, as such, failure of reinsurers to honor their obligations could result in losses to The Hartford. The Hartford evaluates the risk transfer of its reinsurance contracts, the financial condition of its reinsurers and monitors concentrations of credit risk. The Company's monitoring procedures include careful initial selection of its reinsurers, structuring agreements to provide collateral funds where possible, and regularly monitoring the financial condition and ratings of its reinsurers. Reinsurance accounting is followed for ceded transactions when the risk transfer provisions of Statement of Financial Accounting Standard No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, (SFAS 113) have been met. For further discussion see Note 6 of Notes to Consolidated Financial Statements.

For Property & Casualty operations, these reinsurance arrangements are intended to provide greater diversification of business and limit The Hartford's maximum net loss arising from large risks or catastrophes. A major portion of The Hartford's property and casualty reinsurance is effected under general reinsurance contracts known as treaties, or, in some instances, is negotiated on an individual risk basis, known as facultative reinsurance. The Hartford also has in-force excess of loss contracts with reinsurers that protect it against a specified part or all of a layer of losses over stipulated amounts.

In accordance with normal industry practice, Life is involved in both the cession and assumption of insurance with other insurance and reinsurance companies. As of December 31, 2006 and 2005, the Company's policy for the largest amount of life insurance retained on any one life by any one of the life operations was approximately \$5. In addition, Life has reinsured the majority of the minimum death benefit guarantees as well as 23% of the guaranteed minimum withdrawal benefits offered in connection with its variable annuity contracts. Life also assumes reinsurance from other insurers. For the years ended December 31, 2006, 2005 and 2004, Life did not make any significant changes in the terms under which reinsurance is ceded to other insurers.

Investment Operations

The Hartford's investment portfolios are primarily divided between Life and Property & Casualty. The investment portfolios of Life and Property & Casualty are managed by Hartford Investment Management Company (HIMCO), a wholly-owned subsidiary of The Hartford. HIMCO manages the portfolios to maximize economic value, while attempting to generate the income necessary to support the Company's various product obligations, within internally established objectives, guidelines and risk tolerances. The portfolio objectives and guidelines are developed based upon the asset/liability profile, including duration, convexity and other characteristics within specified risk tolerances. The risk tolerances considered include, for example, asset and credit issuer allocation limits, maximum portfolio below investment grade holdings and foreign currency exposure. The Company attempts to minimize adverse impacts to the portfolio and the Company's results of operations from changes in economic conditions through asset allocation limits, asset/liability duration matching and through the use of derivatives. For further discussion of HIMCO's portfolio management approach, see the Investments General section of the MD&A.

In addition to managing the general account assets of the Company, HIMCO is also a Securities and Exchange Commission (SEC) registered investment advisor for third party institutional clients, a sub-advisor for certain mutual funds offered by Life and serves as the sponsor and collateral manager for synthetic collateralized loan obligations. HIMCO specializes in investment management that incorporates proprietary research and active management within a disciplined risk framework to provide value added returns versus peers and benchmarks. As of December 31, 2006 and 2005, the fair value of HIMCO's total assets under management was approximately \$131.2 billion and \$115.9 billion, respectively, of which \$7.2 billion and \$4.7 billion, respectively, were held in HIMCO managed third party accounts.

Regulation and Premium Rates

Insurance companies are subject to comprehensive and detailed regulation and supervision throughout the United States. The extent of such regulation varies, but generally has its source in statutes which delegate regulatory, supervisory and administrative powers to state insurance departments. Such powers relate to, among other things, the

standards of solvency that must be met and maintained; the licensing of insurers and their agents; the nature of and limitations on investments; establishing premium rates; claim handling and trade practices; restrictions on the size of risks which may be insured under a single policy; deposits of securities for the benefit of policyholders; approval of policy forms; periodic examinations of the affairs of companies; annual and other reports required to be filed on the financial condition of companies or for other purposes; fixing maximum interest rates on life insurance policy loans and minimum rates for accumulation of surrender values; and the adequacy of reserves and other necessary provisions for unearned premiums, unpaid losses and loss adjustment expenses and other liabilities, both reported and unreported.

Most states have enacted legislation that regulates insurance holding company systems such as The Hartford. This legislation provides that each insurance company in the system is required to register with the insurance department of its state of domicile and furnish

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information concerning the operations of companies within the holding company system which may materially affect the operations, management or financial condition of the insurers within the system. All transactions within a holding company system affecting insurers must be fair and equitable. Notice to the insurance departments is required prior to the consummation of transactions affecting the ownership or control of an insurer and of certain material transactions between an insurer and any entity in its holding company system. In addition, certain of such transactions cannot be consummated without the applicable insurance department's prior approval. In the jurisdictions in which the Company's insurance company subsidiaries are domiciled, the acquisition of more than 10% of The Hartford's outstanding common stock would require the acquiring party to make various regulatory filings.

The extent of insurance regulation on business outside the United States varies significantly among the countries in which The Hartford operates. Some countries have minimal regulatory requirements, while others regulate insurers extensively. Foreign insurers in many countries are faced with greater restrictions than domestic competitors domiciled in that particular jurisdiction. The Hartford's international operations are comprised of insurers licensed in their respective countries.

Employees

The Hartford had approximately 31,000 employees as of December 31, 2006.

Available Information

The Hartford makes available, free of charge, on or through its Internet website (<http://www.thehartford.com>) The Hartford's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after The Hartford electronically files such material with, or furnishes it to, the SEC.

Item 1A. RISK FACTORS

Investing in The Hartford involves risk. In deciding whether to invest in The Hartford, you should carefully consider the following risk factors, any of which could have a significant or material adverse effect on the business, financial condition, operating results or liquidity of The Hartford. This information should be considered carefully together with the other information contained in this report and the other reports and materials filed by The Hartford with the Securities and Exchange Commission.

It is difficult for us to predict our potential exposure for asbestos and environmental claims and our ultimate liability may exceed our currently recorded reserves, which may have a material adverse effect on our operating results, financial condition and liquidity.

We continue to receive asbestos and environmental claims. Significant uncertainty limits the ability of insurers and reinsurers to estimate the ultimate reserves necessary for unpaid losses and related expenses for both environmental and particularly asbestos claims. We believe that the actuarial tools and other techniques we employ to estimate the ultimate cost of claims for more traditional kinds of insurance exposure are less precise in estimating reserves for our asbestos and environmental exposures. Traditional actuarial reserving techniques cannot reasonably estimate the ultimate cost of these claims, particularly during periods where theories of law are in flux. Accordingly, the degree of variability of reserve estimates for these exposures is significantly greater than for other more traditional exposures. It is also not possible to predict changes in the legal and legislative environment and their effect on the future development of asbestos and environmental claims. Although potential Federal asbestos-related legislation has been considered in the Senate, it is uncertain whether such legislation will be considered or be enacted in the future and, if so, what its effect would be on our aggregate asbestos liabilities. Because of the significant uncertainties that limit the ability of insurers and reinsurers to estimate the ultimate reserves necessary for unpaid losses and related expenses for both environmental and particularly asbestos claims, the ultimate liabilities may exceed the currently recorded reserves. Any such additional liability cannot be reasonably estimated now but could have a material adverse effect on our consolidated operating results, financial condition and liquidity.

The occurrence of one or more terrorist attacks in the geographic areas we serve or the threat of terrorism in general may have a material adverse effect on our business, consolidated operating results, financial condition or liquidity.

The occurrence of one or more terrorist attacks in the geographic areas we serve could result in substantially higher claims under our insurance policies than we have anticipated. Private sector catastrophe reinsurance is extremely limited and generally unavailable for terrorism losses caused by attacks with nuclear, biological, chemical or

radiological weapons. Reinsurance coverage from the federal government under the Terrorism Risk Insurance Act of 2002, as extended through 2007, is also limited. Moreover, it is uncertain whether a federal terrorism risk insurance program similar to the Terrorism Risk Insurance Extension Act of 2005 will be enacted to cover events occurring after December 31, 2007. Accordingly, the effects of a terrorist attack in the geographic areas we serve may result in claims and related losses for which we do not have adequate reinsurance. This would likely cause us to increase our reserves, adversely affect our earnings during the period or periods affected and, if significant enough, could adversely affect our liquidity and financial condition. Further, the continued threat of terrorism and the occurrence of terrorist attacks, as well as heightened security measures and military action in response to these threats and attacks, may cause significant volatility in global financial markets, disruptions to commerce and reduced economic activity. These consequences could have an adverse effect on the value of the assets in our investment portfolio as well as those in our separate accounts. The continued threat of terrorism also could result in increased

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reinsurance prices and potentially cause us to retain more risk than we otherwise would retain if we were able to obtain reinsurance at lower prices. Terrorist attacks also could disrupt our operations centers in the U.S. or abroad. As a result, it is possible that any, or a combination of all, of these factors may have a material adverse effect on our business, consolidated operating results, financial condition and liquidity.

We may incur losses due to our reinsurers being unwilling or unable to meet their obligations under reinsurance contracts and the availability, pricing and adequacy of reinsurance may not be sufficient to protect us against losses. As an insurer, we frequently seek to reduce the losses that may arise from catastrophes, or other events that can cause unfavorable results of operations, through reinsurance. Under these reinsurance arrangements, other insurers assume a portion of our losses and related expenses; however, we remain liable as the direct insurer on all risks reinsured. Consequently, ceded reinsurance arrangements do not eliminate our obligation to pay claims and we are subject to our reinsurers' credit risk with respect to our ability to recover amounts due from them. Although we evaluate periodically the financial condition of our reinsurers to minimize our exposure to significant losses from reinsurer insolvencies, our reinsurers may become financially unsound or choose to dispute their contractual obligations by the time their financial obligations become due. The inability or unwillingness of any reinsurer to meet its financial obligations to us could negatively affect our consolidated operating results. In addition, market conditions beyond our control determine the availability and cost of the reinsurance we are able to purchase. Recently, the price of reinsurance has increased significantly, and may continue to increase. No assurances can be made that reinsurance will remain continuously available to us to the same extent and on the same terms and rates as are currently available. If we were unable to maintain our current level of reinsurance or purchase new reinsurance protection in amounts that we consider sufficient and at prices that we consider acceptable, we would have to either accept an increase in our net liability exposure, reduce the amount of business we write, or develop other alternatives to reinsurance.

We are exposed to significant capital markets risk related to changes in interest rates, equity prices and foreign exchange rates which may adversely affect our results of operations, financial condition or cash flows.

We are exposed to significant capital markets risk related to changes in interest rates, equity prices and foreign currency exchange rates. Our exposure to interest rate risk relates primarily to the market price and cash flow variability associated with changes in interest rates. A rise in interest rates will reduce the net unrealized gain position of our investment portfolio, increase interest expense on our variable rate debt obligations and, if long-term interest rates rise dramatically within a six to twelve month time period, certain of our Life businesses may be exposed to disintermediation risk. Disintermediation risk refers to the risk that our policyholders may surrender their contracts in a rising interest rate environment, requiring us to liquidate assets in an unrealized loss position. Due to the long-term nature of the liabilities associated with certain of our Life businesses, such as structured settlements and guaranteed benefits on variable annuities, sustained declines in long term interest rates may subject us to reinvestment risks and increased hedging costs. Our primary exposure to equity risk relates to the potential for lower earnings associated with certain of our Life businesses, such as variable annuities, where fee income is earned based upon the fair value of the assets under management. In addition, certain of our Life products offer guaranteed benefits which increase our potential benefit exposure should equity markets decline. We are also exposed to interest rate and equity risk based upon the discount rate and expected long-term rate of return assumptions associated with our pension and other post-retirement benefit obligations. Sustained declines in long-term interest rates or equity returns likely would have a negative effect on the funded status of these plans. Our primary foreign currency exchange risks are related to net income from foreign operations, non U.S. dollar denominated investments, investments in foreign subsidiaries, the yen denominated individual fixed annuity product, and certain guaranteed benefits associated with the Japan variable annuity. These risks relate to the potential decreases in value and income resulting from a strengthening or weakening in foreign exchange rates versus the U.S. dollar. In general, the weakening of foreign currencies versus the U.S. dollar will unfavorably affect net income from foreign operations, the value of non-U.S. dollar denominated investments, investments in foreign subsidiaries and realized gains or losses on the yen denominated individual fixed annuity product. In comparison, a strengthening of the Japanese yen in comparison to the U.S. dollar and other currencies may increase our exposure to the guarantee benefits associated with the Japan variable annuity. If significant, declines in equity prices, changes in U.S. interest rates and the strengthening or weakening of foreign currencies against the U.S. dollar, individually or in tandem, could have a material adverse effect on our consolidated results of operations,

financial condition or cash flows.

We may be unable to effectively mitigate the impact of equity market volatility on our financial position and results of operations arising from obligations under annuity product guarantees, which may affect our consolidated results of operations, financial condition or cash flows.

Our primary exposure to equity risk relates to the potential for lower earnings associated with certain of our life businesses where fee income is earned based upon the fair value of the assets under management. In addition, some of the products offered by these businesses, especially variable annuities, offer certain guaranteed benefits which increase our potential benefit exposure as the equity markets decline. We are subject to equity market volatility related to these benefits, especially the guaranteed minimum death benefit (GMDB), guaranteed minimum withdrawal benefit (GMWB) and guaranteed minimum income benefit (GMIB) offered with variable annuity products. We use reinsurance structures and have modified benefit features to mitigate the exposure associated with GMDB. We also use reinsurance in combination with derivative instruments to minimize the claim exposure and the volatility of net income associated with the GMWB liability. While we believe that these and other actions we have taken mitigate the risks related to these benefits, we are subject to the risks that reinsurers or derivative counterparties are unable or unwilling to pay, that other risk management procedures prove ineffective or that unanticipated policyholder behavior, combined with adverse market events, produces

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economic losses beyond the scope of the risk management techniques employed, which individually or collectively may have a material adverse effect on our consolidated results of operations, financial condition or cash flows.

Regulatory proceedings or private claims relating to incentive compensation or payments made to brokers or other producers, alleged anti-competitive conduct and other sales practices could have a material adverse effect on us.

We have received multiple regulatory inquiries regarding our compensation arrangements with brokers and other producers. For example, in June 2004, the Company received a subpoena from the New York Attorney General's Office in connection with its inquiry into compensation arrangements between brokers and carriers. In mid-September 2004 and subsequently, the Company has received additional subpoenas from the New York Attorney General's Office, which relate more specifically to possible anti-competitive activity among brokers and insurers. On October 14, 2004, the New York Attorney General's Office filed a civil complaint against Marsh & McLennan Companies, Inc., and Marsh, Inc. (collectively, "Marsh"). The complaint alleges, among other things, that certain insurance companies, including the Company, participated with Marsh in arrangements to submit inflated bids for business insurance and paid contingent commissions to ensure that Marsh would direct business to them. The Company was not joined as a defendant in the action, which has since settled.

Since the beginning of October 2004, the Company has received subpoenas or other information requests from Attorneys General and regulatory agencies in more than a dozen jurisdictions regarding broker compensation, possible anti-competitive activity and sales practices. These inquiries have concerned lines of business in both our Property & Casualty and Life operations. The Company may continue to receive additional subpoenas and other information requests from Attorneys General or other regulatory agencies regarding similar issues. The Company intends to continue cooperating fully with these investigations, and is conducting an internal review, with the assistance of outside counsel, regarding broker compensation issues in its Property & Casualty and Group Benefits operations. Although no regulatory action has been initiated against the Company in connection with the allegations described in the civil complaint, it is possible that one or more other regulatory agencies may pursue action against the Company or one or more of its employees in the future on this matter or on other similar matters. If such an action is brought, it could have a material adverse effect on the Company.

Regulatory and market-driven changes may affect our practices relating to the payment of incentive compensation to brokers and other producers, including changes that have been announced and those which may occur in the future, and could have a material adverse effect on us in the future.

We pay brokers and independent agents commissions and other forms of incentive compensation in connection with the sale of many of our insurance products. Since the New York Attorney General's Office filed a civil complaint against Marsh on October 14, 2004, several of the largest national insurance brokers, including Marsh, Aon Corporation and Willis Group Holdings Limited, have announced that they have discontinued the use of contingent compensation arrangements. Other industry participants may make similar, or different, determinations in the future. In addition, legal, legislative, regulatory, business or other developments may require changes to industry practices relating to incentive compensation.

Pursuant to settlement agreements reached with regulators, several insurance companies have agreed to restrictions on the payment of contingent compensation relating to the placement of excess casualty insurance policies. These insurers have agreed that the restrictions may be extended in time, and to other property and casualty lines, if insurers in a given line or segment, that together represent more than 65% of the market share in the insurance line (based upon national gross written premiums), do not pay contingent compensation. On November 30, 2006, the New York Attorney General's Office notified these insurers that the 65% threshold had been reached for a number of insurance lines, including personal automobile and homeowners insurance. As a result, beginning January 1, 2007, these insurers were prohibited from paying contingent compensation relating to the placement of these types of insurance. In addition, on December 21, 2006, Chubb Corporation agreed to forego the payment of contingent compensation for all P&C insurance lines pursuant to a settlement agreement reached with regulators. These insurers, including Chubb, have also agreed to support legislation and regulations to abolish contingent compensation and to require greater disclosure of compensation. At this time, it is not possible to predict the effect of these announced or potential future changes on our business or distribution strategies, but such changes could have a material adverse effect on us in the future.

Our consolidated results of operations, financial condition or cash flows in a particular period or periods may be adversely affected by unfavorable loss development.

Our success depends upon our ability to accurately assess the risks associated with the businesses that we insure. We establish loss reserves to cover our estimated liability for the payment of all unpaid losses and loss expenses incurred with respect to premiums earned on the policies that we write. Loss reserves do not represent an exact calculation of liability. Rather, loss reserves are estimates of what we expect the ultimate settlement and administration of claims will cost, less what has been paid to date. These estimates are based upon actuarial and statistical projections and on our assessment of currently available data, as well as estimates of claims severity and frequency, legal theories of liability and other factors. Loss reserve estimates are refined periodically as experience develops and claims are reported and settled. Establishing an appropriate level of loss reserves is an inherently uncertain process. Because of this uncertainty, it is possible that our reserves at any given time will prove inadequate. Furthermore, since estimates of aggregate loss costs

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for prior accident years are used in pricing our insurance products, we could later determine that our products were not priced adequately to cover actual losses and related loss expenses in order to generate a profit. To the extent we determine that actual losses and related loss expenses exceed our expectations and reserves recorded in our financial statements, we will be required to increase reserves. Increases in reserves would be recognized as an expense during the period or periods in which these determinations are made, thereby adversely affecting our results of operations for the related period or periods. Depending on the severity and timing of these determinations, this could have a material adverse effect on our consolidated results of operations, financial condition or cash flows in a particular quarterly or annual period.

We are particularly vulnerable to losses from the incidence and severity of catastrophes, both natural and man-made, the occurrence of which may have a material adverse effect on our financial condition, consolidated results of operations or cash flows in a particular quarterly or annual period.

Our property and casualty insurance operations expose us to claims arising out of catastrophes. Catastrophes can be caused by various unpredictable events, including earthquakes, hurricanes, hailstorms, severe winter weather, fires, tornadoes, explosions and other natural or man-made disasters. We also face substantial exposure to losses resulting from acts of terrorism, disease pandemics and political instability. The geographic distribution of our business subjects us to catastrophe exposure for natural events occurring in a number of areas, including, but not limited to, hurricanes in Florida, the Gulf Coast, the Northeast and the Atlantic coast regions of the United States, and earthquakes in California and the New Madrid region of the United States. Further we expect that increases in the values and concentrations of insured property in these areas will increase the severity of catastrophic events in the future. In addition, in the aftermath of the 2004 and 2005 hurricane season, third-party catastrophe loss models for hurricane loss events were updated to incorporate medium-term forecasts of increased hurricane frequency and severity. Our life insurance operations are also exposed to risk of loss from catastrophes. For example, natural or man-made disasters or a disease pandemic such as could arise from avian flu, could significantly increase our mortality and morbidity experience. Policyholders may be unable to meet their obligations to pay premiums on our insurance policies or make deposits on our investment products. Our liquidity could be constrained by a catastrophe, or multiple catastrophes, which result in extraordinary losses or a downgrade of our debt or financial strength ratings. In addition, in part because accounting rules do not permit insurers to reserve for such catastrophic events until they occur, claims from catastrophic events could have a material adverse effect on our financial condition, consolidated results of operations or cash flows in a particular quarterly or annual period.

Competitive activity may adversely affect our market share and profitability, which could have an adverse effect on our business, results of operations or financial condition.

The insurance industry is highly competitive. Our competitors include other insurers and, because many of our products include an investment component, securities firms, investment advisers, mutual funds, banks and other financial institutions. In recent years, there has been substantial consolidation and convergence among companies in the insurance and financial services industries resulting in increased competition from large, well-capitalized insurance and financial services firms that market products and services similar to ours. Many of these firms also have been able to increase their distribution systems through mergers or contractual arrangements. These competitors compete with us for producers such as brokers and independent agents. Larger competitors may have lower operating costs and an ability to absorb greater risk while maintaining their financial strength ratings, thereby allowing them to price their products more competitively. These highly competitive pressures could result in increased pricing pressures on a number of our products and services, particularly as competitors seek to win market share, and may harm our ability to maintain or increase our profitability. Because of the highly competitive nature of the insurance industry, there can be no assurance that we will continue to effectively compete with our industry rivals, or that competitive pressure will not have a material adverse effect on our business, results of operations or financial condition.

We may experience unfavorable judicial or legislative developments that would adversely affect our results of operations, financial condition or liquidity.

The Hartford is involved in claims litigation arising in the ordinary course of business, both as a liability insurer defending or providing indemnity for third-party claims brought against insureds and as an insurer defending coverage claims brought against it. The Hartford accounts for such activity through the establishment of unpaid loss and loss

adjustment expense reserves. The Company is also involved in legal actions that do not arise in the ordinary course of business, some of which assert claims for substantial amounts. It is not possible to predict changes in the judicial and legislative environment and their impact on the future development of the adequacy of our loss reserves, particularly reserves for longer-tailed lines of business, including asbestos and environmental reserves. Pervasive or dramatic changes in the judicial environment relating to matters such as trends in the size of jury awards, developments in the law relating to the liability of insurers or tort defendants, and rulings concerning the availability or amount of certain types of damages could cause our ultimate liabilities to change from our current expectations. Similarly, changes in federal or state tort litigation laws or other applicable laws could have the same effect. To the extent that judicial or legislative developments cause our ultimate liabilities to increase from our current expectations, they could have a material adverse effect on the Company's consolidated results of operations, financial condition or liquidity.

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Potential changes in domestic and foreign regulation may increase our business costs and required capital levels, which could adversely affect our business, consolidated operating results, financial condition or liquidity.

We are subject to extensive laws and regulations. These laws and regulations are complex and subject to change. Moreover, they are administered and enforced by a number of different governmental authorities, including foreign regulators, state insurance regulators, state securities administrators, the Securities and Exchange Commission, the New York Stock Exchange, the National Association of Securities Dealers, the U.S. Department of Justice, and state attorneys general, each of which exercises a degree of interpretive latitude. Consequently, we are subject to the risk that compliance with any particular regulator's or enforcement authority's interpretation of a legal issue may not result in compliance with another regulator's or enforcement authority's interpretation of the same issue, particularly when compliance is judged in hindsight. In addition, there is risk that any particular regulator's or enforcement authority's interpretation of a legal issue may change over time to our detriment, or that changes in the overall legal environment may, even absent any particular regulator's or enforcement authority's interpretation of a legal issue changing, cause us to change our views regarding the actions we need to take from a legal risk management perspective, thus necessitating changes to our practices that may, in some cases, limit our ability to grow and improve the profitability of our business.

State insurance laws regulate most aspects of our U.S. insurance businesses, and our insurance subsidiaries are regulated by the insurance departments of the states in which they are domiciled and licensed. State laws in the U.S. grant insurance regulatory authorities broad administrative powers with respect to, among other things:

- licensing companies and agents to transact business;

- calculating the value of assets to determine compliance with statutory requirements;

- mandating certain insurance benefits;

- regulating certain premium rates;

- reviewing and approving policy forms;

- regulating unfair trade and claims practices, including through the imposition of restrictions on marketing and sales practices, distribution arrangements and payment of inducements;

- establishing statutory capital and reserve requirements and solvency standards;

- fixing maximum interest rates on insurance policy loans and minimum rates for guaranteed crediting rates on life insurance policies and annuity contracts;

- approving changes in control of insurance companies;

- restricting the payment of dividends and other transactions between affiliates;

- establishing assessments and surcharges for guaranty funds, second-injury funds and other mandatory pooling arrangements; and

- regulating the types, amounts and valuation of investments.

State insurance regulators and the National Association of Insurance Commissioners, or NAIC, regularly re-examine existing laws and regulations applicable to insurance companies and their products. Our international operations are subject to regulation in the relevant jurisdictions in which they operate, which in many ways is similar to the state regulation outlined above, with similar related restrictions. Our asset management operations are also subject to extensive regulation in the various jurisdictions where they operate. These regulations are primarily intended to

protect investors in the securities markets or investment advisory clients and generally grant supervisory authorities broad administrative powers. Changes in all of these laws and regulations, or in interpretations thereof, are often made for the benefit of the consumer at the expense of the insurer and thus could have a material adverse effect on our business, consolidated operating results, financial condition and liquidity. Compliance with these laws and regulations is also time consuming and personnel-intensive, and changes in these laws and regulations may increase materially our direct and indirect compliance costs and other expenses of doing business, thus having an adverse effect on our business, consolidated operating results, financial condition and liquidity.

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Our business, results of operations and financial condition may be adversely affected by general domestic and international economic and business conditions that are less favorable than anticipated.

Factors such as consumer spending, business investment, government spending, the volatility and strength of the capital markets, and inflation all affect the business and economic environment and, ultimately, the amount and profitability of business we conduct. For example, in an economic downturn characterized by higher unemployment, lower family income, lower corporate earnings, lower business investment and consumer spending, the demand for financial and insurance products could be adversely affected. Further, given that we offer our products and services in North America, Japan, Europe and South America, we are exposed to these risks in multiple geographic locations. Our operations are subject to different local political, regulatory, business and financial risks and challenges which may affect the demand for our products and services, the value of our investment portfolio, the required levels of our capital and surplus, and the credit quality of local counterparties. These risks include, for example, political, social or economic instability in countries in which we operate, fluctuations in foreign currency exchange rates, credit risks of our local borrowers and counterparties, lack of local business experience in certain markets, and, in certain cases, risks associated with the potential incompatibility with partners. Additionally, some of our recent growth is due to our expansion into new markets for our investment products, primarily in Japan. During 2006, our sales of investment products in Japan declined significantly from the prior year, as competition increased from both domestic and foreign competitors. Looking forward, our overall success in these new markets will depend on our ability to succeed despite differing and dynamic economic, social and political conditions. We may not succeed in developing and implementing policies and strategies that are effective in each location where we do business and we cannot guarantee that the inability to successfully address the risks related to economic conditions in all of the geographic locations where we conduct business will not have a material adverse effect on our business, results of operations or financial condition. *We may experience difficulty in marketing and distributing products through our current and future distribution channels.*

We distribute our annuity, life and certain property and casualty insurance products through a variety of distribution channels, including brokers, independent agents, broker-dealers, banks, wholesalers, affinity partners, our own internal sales force and other third party organizations. In some areas of our business, we generate a significant portion of our business through individual third party arrangements. For example, we generated approximately 66% of our personal lines earned premium in 2006 under an exclusive licensing arrangement with AARP that continues until January 1, 2020. We periodically negotiate provisions and renewals of these relationships and there can be no assurance that such terms will remain acceptable to us or such third parties. An interruption in our continuing relationship with certain of these third parties could materially affect our ability to market our products.

Our business, results of operations, financial condition or liquidity may be adversely affected by the emergence of unexpected and unintended claim and coverage issues.

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may either extend coverage beyond our underwriting intent or increase the frequency or severity of claims. In some instances, these changes may not become apparent until some time after we have issued insurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance contracts may not be known for many years after a contract is issued and this liability may have a material adverse effect on our business, results of operations, financial condition or liquidity at the time it becomes known.

We may experience a downgrade in our financial strength or credit ratings which may make our products less attractive, increase our cost of capital, and inhibit our ability to refinance our debt, which would have an adverse effect on our business, consolidated operating results, financial condition and liquidity.

Financial strength and credit ratings, including commercial paper ratings, have become an increasingly important factor in establishing the competitive position of insurance companies. Rating organizations assign ratings based upon several factors. While most of the factors relate to the rated company, some of the factors relate to the views of the rating organization, general economic conditions, and circumstances outside the rated company's control. In addition, rating organizations may employ different models and formulas to assess the financial strength of a rated company, and from time to time rating organizations have, in their discretion, altered these models. Changes to the models,

general economic conditions, or circumstances outside our control could impact a rating organization's judgment of its rating and the subsequent rating it assigns us. We cannot predict what actions rating organizations may take, or what actions we may be required to take in response to the actions of rating organizations, which may adversely affect us. Our financial strength ratings, which are intended to measure our ability to meet policyholder obligations, are an important factor affecting public confidence in most of our products and, as a result, our competitiveness. A downgrade in our financial strength ratings, or an announced potential downgrade, of one of our principal insurance subsidiaries could affect our competitive position in the insurance industry and make it more difficult for us to market our products, as potential customers may select companies with higher financial strength ratings. The interest rates we pay on our borrowings are largely dependent on our credit ratings. A downgrade of our credit ratings, or an announced potential downgrade, could affect our ability to raise additional debt with terms and conditions similar to our current debt, and accordingly, likely increase our cost of capital. In addition, a downgrade of our credit ratings could make it more difficult to raise capital to refinance any maturing debt obligations, to support business growth at our insurance subsidiaries and to maintain or improve the current financial strength ratings of our principal insurance subsidiaries described above. As a result, it is possible that any, or a

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combination of all, of these factors may have a material adverse effect on our business, consolidated operating results, financial condition and liquidity.

Limits on the ability of our insurance subsidiaries to pay dividends to us may adversely affect our liquidity.

The Hartford Financial Services Group, Inc. is a holding company with no significant operations. Our principal asset is the stock of our insurance subsidiaries. State insurance regulatory authorities limit the payment of dividends by insurance subsidiaries. In addition, competitive pressures generally require certain of our insurance subsidiaries to maintain financial strength ratings. These restrictions and other regulatory requirements affect the ability of our insurance subsidiaries to make dividend payments. Limits on the ability of the insurance subsidiaries to pay dividends could adversely affect our liquidity, including our ability to pay dividends to shareholders and service our debt.

As a property and casualty insurer, the premium rates we are able to charge and the profits we are able to obtain are affected by the actions of state insurance departments that regulate our business, the cyclical nature of the business in which we compete and our ability to adequately price the risks we underwrite, which may have a material adverse effect on our consolidated results of operations in a particular quarterly or annual period or periods.

Pricing adequacy depends on a number of factors, including the ability to obtain regulatory approval for rate changes, proper evaluation of underwriting risks, the ability to project future loss cost frequency and severity based on historical loss experience adjusted for known trends, our response to rate actions taken by competitors, and expectations about regulatory and legal developments and expense levels. We seek to price our property and casualty insurance policies such that insurance premiums and future net investment income earned on premiums received will provide for an acceptable profit in excess of underwriting expenses and the cost of paying claims.

State insurance departments that regulate us often propose premium rate changes for the benefit of the consumer at the expense of the insurer, and may not allow us to reach targeted levels of profitability. In addition to regulating rates, certain states have enacted laws that require a property and casualty insurer conducting business in that state to participate in assigned risk plans, reinsurance facilities, joint underwriting associations and other residual market plans, or to offer coverage to all consumers, often restricting an insurer's ability to charge the price it might otherwise charge. In these markets, we may be compelled to underwrite significant amounts of business at lower than desired rates, participate in the operating losses of residual market plans or pay assessments to fund operating deficits of state-sponsored funds, possibly leading to an unacceptable returns on equity. Laws and regulations of many states also limit an insurer's ability to withdraw from one or more lines of insurance in the state, except pursuant to a plan that is approved by the state insurance department. Additionally, certain states require insurers to participate in guaranty funds for impaired or insolvent insurance companies. These funds periodically assess losses against all insurance companies doing business in the state. Any of these factors could have a material adverse effect on our consolidated results of operations in a particular quarterly or annual period or periods.

Additionally, the property and casualty insurance market is historically cyclical, experiencing periods characterized by relatively high levels of price competition, less restrictive underwriting standards and relatively low premium rates, followed by periods of relatively low levels of competition, more selective underwriting standards and relatively high premium rates. Prices tend to increase for a particular line of business when insurance carriers have incurred significant losses in that line of business in the recent past or when the industry as a whole commits less of its capital to writing exposures in that line of business. Prices tend to decrease when recent loss experience has been favorable or when competition among insurance carriers increases. In a number of product lines and states, we are currently experiencing premium rate reductions. In these product lines and states, there is a risk that the premium we charge may ultimately prove to be inadequate as reported losses emerge. Even in a period of rate increases, there is a risk that regulatory constraints, price competition or incorrect pricing assumptions could prevent us from achieving targeted returns. Inadequate pricing could have a material adverse effect on our consolidated results of operations in a particular quarterly or annual period or periods.

If we are unable to maintain the availability of our systems and safeguard the security of our data due to the occurrence of disasters or other unanticipated events, our ability to conduct business may be compromised, which may have a material adverse effect on our business, consolidated results of operations, financial condition or cash flows.

We use computer systems to store, retrieve, evaluate and utilize customer and company data and information. Our computer, information technology and telecommunications systems, in turn, interface with and rely upon third-party systems. Our business is highly dependent on our ability, and the ability of certain affiliated third parties, to access these systems to perform necessary business functions, such as providing insurance quotes, processing premium payments, making changes to existing policies, filing and paying claims, and providing customer support. Systems failures or outages could compromise our ability to perform these functions in a timely manner, which could harm our ability to conduct business and hurt our relationships with our business partners and customers. In the event of a disaster such as a natural catastrophe, an industrial accident, a blackout, a computer virus, a terrorist attack or war, our systems may be inaccessible to our employees, customers or business partners for an extended period of time. Even if our employees are able to report to work, they may be unable to perform their duties for an extended period of time if our data or systems are disabled or destroyed. Our systems could also be subject to physical and electronic break-ins, and subject to similar disruptions from unauthorized tampering with our systems. This may impede or interrupt our business operations and may have a material adverse effect on our business, consolidated operating results, financial condition or liquidity.

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If we experience difficulties arising from outsourcing relationships, our ability to conduct business may be compromised.

We outsource certain technology and business functions to third parties and expect to do so selectively in the future. If we do not effectively develop and implement our outsourcing strategy, third party providers do not perform as anticipated, or we experience problems with a transition, we may experience operational difficulties, increased costs and a loss of business that may have a material adverse effect on our consolidated results of operations in a particular quarterly or annual period or periods.

Potential changes in Federal or State tax laws could adversely affect our business, consolidated operating results or financial condition.

Many of the products that the Company sells currently benefit from one or more forms of tax-favored status under current federal and state income tax regimes. For example, the Company sells life insurance policies which benefit from the deferral or elimination of taxation on earnings accrued under the policy, as well as permanent exclusion of certain death benefits that may be paid to policyholders' beneficiaries. We also sell annuity contracts which allow the policyholders to defer the recognition of taxable income earned within the contract. Other products that the Company sells also enjoy similar, as well as other, types of tax advantages. The Company also benefits from certain tax benefits, including but not limited to, tax-exempt bond interest, dividends-received deductions, tax credits (such as foreign tax credits), and insurance reserve deductions.

There is risk that federal and/or state tax legislation could be enacted that would lessen or eliminate some or all of the tax advantages currently benefiting the Company or its policyholders. This could occur in the context of deficit reduction or several types of fundamental tax reform. The effects of any such changes could result in materially lower product sales, lapses of policies currently held, and/or materially higher corporate taxes that would be incurred by the Company.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

The Hartford owns the land and buildings comprising its Hartford location and other properties within the greater Hartford, Connecticut area which total approximately 1.9 million of the 2.1 million square feet owned by the Company in the aggregate. In addition, The Hartford leases approximately 5.4 million square feet throughout the United States and approximately 175,000 square feet in other countries. All of the properties owned or leased are used by one or more of all ten operating segments, depending on the location. For more information on operating segments, see Part 1, Item 1, Business of The Hartford Reporting Segments. The Company believes its properties and facilities are suitable and adequate for current operations.

Item 3. LEGAL PROCEEDINGS

The Hartford is involved in claims litigation arising in the ordinary course of business, both as a liability insurer defending or providing indemnity for third-party claims brought against insureds and as an insurer defending coverage claims brought against it. The Hartford accounts for such activity through the establishment of unpaid loss and loss adjustment expense reserves. Subject to the uncertainties discussed below under the caption Asbestos and Environmental Claims, management expects that the ultimate liability, if any, with respect to such ordinary-course claims litigation, after consideration of provisions made for potential losses and costs of defense, will not be material to the consolidated financial condition, results of operations or cash flows of The Hartford.

The Hartford is also involved in other kinds of legal actions, some of which assert claims for substantial amounts. These actions include, among others, putative state and federal class actions seeking certification of a state or national class. Such putative class actions have alleged, for example, underpayment of claims or improper underwriting practices in connection with various kinds of insurance policies, such as personal and commercial automobile, property, life and inland marine; improper sales practices in connection with the sale of life insurance and other investment products; and improper fee arrangements in connection with mutual funds and structured settlements. The Hartford also is involved in individual actions in which punitive damages are sought, such as claims alleging bad faith in the handling of insurance claims. Like many other insurers, The Hartford also has been joined in actions by asbestos plaintiffs asserting that insurers had a duty to protect the public from the dangers of asbestos and in a putative

class action filed in West Virginia state court by asbestos plaintiffs alleging that insurers committed unfair trade practices by asserting defenses on behalf of their policyholders in the underlying asbestos cases. Management expects that the ultimate liability, if any, with respect to such lawsuits, after consideration of provisions made for estimated losses, will not be material to the consolidated financial condition of The Hartford. Nonetheless, given the large or indeterminate amounts sought in certain of these actions, and the inherent unpredictability of litigation, an adverse outcome in certain matters could, from time to time, have a material adverse effect on the Company's consolidated results of operations or cash flows in particular quarterly or annual periods.

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Broker Compensation Litigation On October 14, 2004, the New York Attorney General's Office filed a civil complaint (the NYAG Complaint) against Marsh Inc. and Marsh & McLennan Companies, Inc. (collectively, Marsh) alleging, among other things, that certain insurance companies, including The Hartford, participated with Marsh in arrangements to submit inflated bids for business insurance and paid contingent commissions to ensure that Marsh would direct business to them. The Hartford was not joined as a defendant in the action, which has since settled. Since the filing of the NYAG Complaint, several private actions have been filed against the Company asserting claims arising from the allegations of the NYAG Complaint.

Two securities class actions, now consolidated, have been filed in the United States District Court for the District of Connecticut alleging claims against the Company and certain of its executive officers under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. The consolidated amended complaint alleges on behalf of a putative class of shareholders that the Company and the four named individual defendants, as control persons of the Company, failed to disclose to the investing public that The Hartford's business and growth was predicated on the unlawful activity alleged in the NYAG Complaint. The class period alleged is August 6, 2003 through October 13, 2004, the day before the NYAG Complaint was filed. The complaint seeks damages and attorneys' fees. Defendants filed a motion to dismiss in June 2005, and, on July 13, 2006, the district court granted the motion. The plaintiffs have noticed an appeal of the dismissal.

Two corporate derivative actions, now consolidated, also have been filed in the same court. The consolidated amended complaint, brought by shareholders on behalf of the Company against its directors and an executive officer, alleges that the defendants knew adverse non-public information about the activities alleged in the NYAG Complaint and concealed and misappropriated that information to make profitable stock trades, thereby breaching their fiduciary duties, abusing their control, committing gross mismanagement, wasting corporate assets, and unjustly enriching themselves. The complaint seeks damages, injunctive relief, disgorgement, and attorneys' fees. Defendants filed a motion to dismiss in May 2005, and the plaintiffs thereafter agreed to stay further proceedings pending resolution of the motion to dismiss the securities class action. All defendants dispute the allegations and intend to defend these actions vigorously.

The Company is also a defendant in a multidistrict litigation in federal district court in New Jersey. There are two consolidated amended complaints filed in the multidistrict litigation, one related to alleged conduct in connection with the sale of property-casualty insurance and the other related to alleged conduct in connection with the sale of group benefits products. The Company and various of its subsidiaries are named in both complaints. The actions assert, on behalf of a class of persons who purchased insurance through the broker defendants, claims under the Sherman Act, the Racketeer Influenced and Corrupt Organizations Act (RICO), state law, and in the case of the group benefits complaint, claims under ERISA arising from conduct similar to that alleged in the NYAG Complaint. The class period alleged is 1994 through the date of class certification, which has not yet occurred. The complaints seek treble damages, injunctive and declaratory relief, and attorneys' fees. On October 3, 2006, the court denied in part the defendants' motions to dismiss the two consolidated amended complaints but found the complaints deficient in other respects and ordered the plaintiffs to file supplemental pleadings. After the plaintiffs filed their supplemental pleadings, the defendants renewed their motions to dismiss. The renewed motions to dismiss and the plaintiffs' motions for class certification are pending. The Company also has been named in two similar actions filed in state courts, which the defendants have removed to federal court. Those actions currently are transferred to the court presiding over the multidistrict litigation. The Company disputes the allegations in all of these actions and intends to defend the actions vigorously. In addition, the Company was joined as a defendant in an action by the California Commissioner of Insurance alleging similar conduct by various insurers in connection with the sale of group benefits products. The Commissioner's action asserted claims under California insurance law and sought injunctive relief only. The Company has settled the Commissioner's action.

Additional complaints may be filed against the Company in various courts alleging claims under federal or state law arising from the conduct alleged in the NYAG Complaint. The Company's ultimate liability, if any, in the pending and possible future suits is highly uncertain and subject to contingencies that are not yet known, such as how many suits will be filed, in which courts they will be lodged, what claims they will assert, what the outcome of investigations by the New York Attorney General's Office and other regulatory agencies will be, the success of defenses that the

Company may assert, and the amount of recoverable damages if liability is established. In the opinion of management, it is possible that an adverse outcome in one or more of these suits could have a material adverse effect on the Company's consolidated results of operations or cash flows in particular quarterly or annual periods.

Fair Credit Reporting Act Putative Class Action In October 2001, a complaint was filed in the United States District Court for the District of Oregon, on behalf of a putative class of homeowners and automobile policyholders from 1999 to the present, alleging that the Company willfully violated the Fair Credit Reporting Act (FCRA) by failing to send appropriate notices to new customers whose initial rates were higher than they would have been had the customer had a more favorable credit report. In July 2003, the district court granted summary judgment for the Company, holding that FCRA's adverse action notice requirement did not apply to the rate first charged for an initial policy of insurance. The plaintiff appealed and, in August 2005, a panel of the United States Court of Appeals for the Ninth Circuit reversed the district court, holding that the adverse action notice requirement applies to new business and that the Company's notices, even when sent, contained inadequate information. Although no court previously had decided the notice requirements applicable to insurers under FCRA, and the district court had not addressed whether the Company's alleged violations of FCRA were willful because it had agreed with the Company's interpretation of FCRA and found no violation, the Court of Appeals further held, over a dissent by one of the

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judges, that the Company's failure to send notices conforming to the Court's opinion constituted a willful violation of FCRA as a matter of law. FCRA provides for a statutory penalty of \$100 to \$1,000 per willful violation. Simultaneously, the Court of Appeals issued decisions in related cases against four other insurers, reversing the district court and holding that those insurers also had violated FCRA in similar ways. On October 3, 2005, the Court of Appeals withdrew its opinion in the Hartford case and issued a revised opinion, which changed certain language of the opinion but not the outcome.

On October 31, 2005, the Company timely filed a petition for rehearing and for rehearing en banc in the Ninth Circuit. While that petition was pending, on January 25, 2006, the Court of Appeals again withdrew its opinion in the Hartford case and issued a second revised opinion. The new opinion vacated the Court's earlier ruling that the Company had willfully violated FCRA as a matter of law and remanded the case to the district court for further proceedings. On February 15, 2006, the Company filed a new petition for rehearing and rehearing en banc, and on April 20, 2006, the Court of Appeals denied the petition. On July 19, 2006, the Company filed a petition for a writ of certiorari in the United States Supreme Court. On September 26, 2006, the Supreme Court granted petitions filed by insurers in two of the related cases, and on January 16, 2007, it heard argument in those cases. The Supreme Court has not yet acted on the Company's petition.

On July 25, 2006, the parties entered into a memorandum of understanding setting forth the essential terms of a class settlement in this action, and, on September 8, 2006, the parties executed and filed with the district court a Stipulation of Settlement. On September 11, 2006, the district court preliminarily approved the settlement and scheduled a hearing for final approval of the settlement for February 26, 2007. The settlement is subject to certain contingencies, including final approval by the district court. If the settlement is completed, management expects that the Company's ultimate obligations under the settlement agreement, after consideration of provisions made for this matter, will not have a material adverse effect on the Company's consolidated results of operations or cash flows in any particular quarterly or annual period.

Blanket Casualty Treaty Litigation The Company is engaged in pending litigation in Connecticut Superior Court against certain of its upper-layer reinsurers under its Blanket Casualty Treaty (BCT). The BCT is a multi-layered reinsurance program providing excess-of-loss coverage in various amounts from the 1930s through the 1980s. The upper layers were first placed in 1950, predominantly with London Market reinsurers, including Lloyd's syndicates reinsured by Equitas. The action seeks, among other relief, damages for the reinsurer defendants' failure to pay certain billings for asbestos and pollution claims.

In December 2003, the Company entered into a global settlement with MacArthur Company, an asbestos insulation distributor and installer then in bankruptcy, for \$1.15 billion. The Company then billed the reinsurer defendants under the BCT for \$117 of the settlement amount. After the reinsurers refused to pay the MacArthur billing, the Company amended its complaint to add, among other things, claims related to that billing. Most of the reinsurer defendants counterclaimed, seeking a declaration that they did not owe reinsurance for the MacArthur settlement.

The litigation concerns under what circumstances losses arising from multiple claims against a single insured may be combined and ceded as a single accident under the BCT so as to reach the upper layers of the program. The BCT contains a unique definition of accident. The application of this definition to the ceded losses is the crux of the dispute.

In April 2005, the Superior Court phased the proceedings, providing for a trial of the MacArthur billing first, in April 2006, with other billings to follow in subsequent trial settings. In September 2005, the London Market reinsurer defendants moved for summary judgment on the MacArthur-related claims. After briefing and oral argument, the Superior Court issued a decision on December 13, 2005, granting the defendants' motion. The Company noticed an appeal to the Connecticut Appellate Court; the appeal has since been transferred to the Connecticut Supreme Court. The Company intends to prosecute its appeal vigorously.

On June 15, 2006, the Company announced an agreement with Equitas and all Lloyd's syndicates reinsured by Equitas (collectively, Equitas) that resolved, with minor exception, all of the Company's ceded and assumed domestic reinsurance exposures with Equitas, including the Company's reinsurance recoveries from Equitas under the BCT. Those recoveries consist predominantly of asbestos and pollution losses, including the billing for the MacArthur settlement. The pending litigation and appeal continue with other upper-layer reinsurers under the BCT.

The outcome of the appeal is uncertain. If the decision of the Superior Court is affirmed on appeal, the Company may be unable to collect from the nonsettling reinsurers not only its billing for the MacArthur settlement but also other current and future billings to which the same relevant facts and legal analysis would apply. The Company has considered the risk of non-collection of these recoveries in its allowance for all uncollectible reinsurance recoverables associated with older, long-term casualty liabilities reported in the Other Operations segment. After consideration of this allowance, management expects that a negative outcome in the BCT litigation would not have a material adverse effect on the Company's consolidated results of operations or cash flows in any particular quarterly or annual period.

Asbestos and Environmental Claims As discussed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption Other Operations (Including Asbestos and Environmental Claims), The Hartford continues to receive asbestos and environmental claims that involve significant uncertainty regarding policy coverage issues. Regarding these claims, The Hartford continually reviews its overall reserve levels and reinsurance coverages, as well as the methodologies it uses to

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estimate its exposures. Because of the significant uncertainties that limit the ability of insurers and reinsurers to estimate the ultimate reserves necessary for unpaid losses and related expenses, particularly those related to asbestos, the ultimate liabilities may exceed the currently recorded reserves. Any such additional liability cannot be reasonably estimated now but could be material to The Hartford's consolidated operating results, financial condition and liquidity.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of security holders of The Hartford Financial Services Group, Inc. during the fourth quarter of 2006.

PART II**Item 5. MARKET FOR THE HARTFORD'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The Hartford's common stock is traded on the New York Stock Exchange (NYSE) under the trading symbol **HIG** . The following table presents the high and low closing prices for the common stock of The Hartford on the NYSE for the periods indicated, and the quarterly dividends declared per share.

	1 st Qtr.	2 nd Qtr.	3 rd Qtr.	4 th Qtr.
2006				
Common Stock Price				
High	\$88.83	\$92.22	\$87.84	\$93.61
Low	79.24	80.63	79.86	84.73
Dividends Declared	0.40	0.40	0.40	0.50
2005				
Common Stock Price				
High	\$73.76	\$77.26	\$81.89	\$89.00
Low	66.06	65.51	73.05	73.75
Dividends Declared	0.29	0.29	0.29	0.30

As of February 16, 2007, the Company had approximately 350,000 shareholders. The closing price of The Hartford's common stock on the NYSE on February 16, 2007 was \$97.09.

On February 22, 2007, The Hartford's Board of Directors declared a quarterly dividend of \$0.50 per share payable on April 2, 2007 to shareholders of record as of March 1, 2007. Dividend decisions are based on and affected by a number of factors, including the operating results and financial requirements of The Hartford and the impact of regulatory restrictions discussed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity Liquidity Requirements.

There are also various legal and regulatory limitations governing the extent to which The Hartford's insurance subsidiaries may extend credit, pay dividends or otherwise provide funds to The Hartford Financial Services Group, Inc. as discussed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity Liquidity Requirements.

See Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, for information related to securities authorized for issuance under equity compensation plans.

Purchases of Equity Securities by the Issuer

The following table summarizes the Company's repurchases of its common stock for each of the three months in the period ended December 31, 2006:

	Total Number of Shares	Total Number of Shares Purchased as Part of	Maximum Number of Shares that May Yet
--	------------------------------	--	--

Period	Purchased	Average Price Paid Per Share	Publicly Announced Plans or Programs	Be Purchased as Part of the Plans or Programs
October 2006	[1] 1,832	\$ 86.96	N/A	[2]
November 2006		\$	N/A	[2]
December 2006		\$	N/A	[2]

[1] Represents shares acquired from employees of the Company for tax withholding purposes in connection with the Company's benefit plans.

[2] \$1 billion of the Company's securities were eligible for repurchase pursuant to the Company's repurchase program.

In February 2007, the Company's Board of Directors authorized the Company to repurchase up to an additional \$1 billion of its securities. This brings the Company's total share repurchase authorization to \$2 billion. The Company's repurchase authorization permits purchases of common stock, which may be in the open market or through privately negotiated transactions. The Company also may enter into derivative transactions to facilitate future repurchases of common stock. The timing of repurchases will be dependent upon several factors, including the market price of the Company's securities, the Company's capital position, consideration of the effect of any repurchases on the Company's financial strength or credit ratings, and other corporate considerations. The repurchase program may be modified, extended or terminated by the Board of Directors at any time. Through February 16, 2007, The Hartford had repurchased approximately \$363 (3.8 million shares) under this program.

Table of Contents**Item 6. SELECTED FINANCIAL DATA***(In millions, except for per share data and combined ratios)*

	2006	2005	2004	2003	2002
Income Statement Data					
Total revenues	\$ 26,500	\$ 27,083	\$ 22,708	\$ 18,719	\$ 16,410
Income (loss) before cumulative effect of accounting changes [1]	2,745	2,274	2,138	(91)	1,000
Net income (loss) [1] [2]	2,745	2,274	2,115	(91)	1,000
Balance Sheet Data					
Total assets	\$326,710	\$285,557	\$259,735	\$225,850	\$181,972
Long-term debt	3,504	4,048	4,308	4,610	4,061
Total stockholders' equity	18,876	15,325	14,238	11,639	10,734
Earnings (Loss) Per Share Data					
Basic earnings (loss) per share [1]					
Income (loss) before cumulative effect of accounting changes [1]	\$ 8.89	\$ 7.63	\$ 7.32	\$ (0.33)	\$ 4.01
Net income (loss) [1] [2]	8.89	7.63	7.24	(0.33)	4.01
Diluted earnings (loss) per share [1] [3]					
Income (loss) before cumulative effect of accounting changes [1]	8.69	7.44	7.20	(0.33)	3.97
Net income (loss) [1] [2]	8.69	7.44	7.12	(0.33)	3.97
Dividends declared per common share	1.70	1.17	1.13	1.09	1.05
Other Data					
Mutual fund assets [4]	\$ 43,732	\$ 32,705	\$ 28,068	\$ 22,462	\$ 15,321
Operating Data Combined ratios					
Ongoing Property & Casualty Operations	89.3	93.2	95.3	96.5	99.1

[1] 2004 includes a \$216 tax benefit related to agreement with the IRS on the resolution of matters pertaining to tax years prior to 2004. 2003 includes an

after-tax charge of \$1.7 billion related to the Company's 2003 asbestos reserve addition, \$40 of after-tax expense related to the settlement of a certain litigation dispute, \$30 of tax benefit in Life primarily related to the favorable treatment of certain tax items arising during the 1996-2002 tax years, and \$27 of after-tax severance charges in Property & Casualty. 2002 includes \$76 tax benefit in Life, \$11 after-tax expense in Life related to a certain litigation dispute and an \$8 after-tax benefit in Life's September 11 exposure.

[2] 2004 includes a \$23 after-tax charge related to the cumulative effect of accounting change for the Company's adoption of the AICPA issued Statement of Position 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for

*Separate
Accounts .*

[3] As a result of the net loss for the year ended December 31, 2003, Statement of Financial Accounting Standards No. 128, Earnings per Share requires the Company to use basic weighted average common shares outstanding in the calculation of the year ended December 31, 2003 diluted earnings (loss) per share, since the inclusion of options of 1.8 would have been antidilutive to the earnings per share calculation. In the absence of the net loss, weighted average common shares outstanding and dilutive potential common shares would have totaled 274.2.

[4] Mutual funds are owned by the shareholders of those funds and not by the Company. As a result, they are not reflected in total assets on the Company's balance sheet.

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**Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS**

(Dollar amounts in millions, except for per share data, unless otherwise stated)

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) addresses the financial condition of The Hartford Financial Services Group, Inc. and its subsidiaries (collectively, The Hartford or the Company) as of December 31, 2006, compared with December 31, 2005, and its results of operations for each of the three years in the period ended December 31, 2006. This discussion should be read in conjunction with the Consolidated Financial Statements and related Notes beginning on page F-1. Certain reclassifications have been made to prior year financial information to conform to the current year presentation.

Certain of the statements contained herein are forward-looking statements. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and include estimates and assumptions related to economic, competitive and legislative developments. These forward-looking statements are subject to change and uncertainty which are, in many instances, beyond the Company's control and have been made based upon management's expectations and beliefs concerning future developments and their potential effect upon the Company. There can be no assurance that future developments will be in accordance with management's expectations or that the effect of future developments on The Hartford will be those anticipated by management. Actual results could differ materially from those expected by the Company, depending on the outcome of various factors, including, but not limited to, those set forth in Part II, Item 1A, Risk Factors. These factors include: the difficulty in predicting the Company's potential exposure for asbestos and environmental claims; the possible occurrence of terrorist attacks; the response of reinsurance companies under reinsurance contracts and the availability, pricing and adequacy of reinsurance to protect the Company against losses; changes in the stock markets, interest rates or other financial markets, including the potential effect on the Company's statutory capital levels; the inability to effectively mitigate the impact of equity market volatility on the Company's financial position and results of operations arising from obligations under annuity product guarantees; the Company's potential exposure arising out of regulatory proceedings or private claims relating to incentive compensation or payments made to brokers or other producers and alleged anti-competitive conduct; the uncertain effect on the Company of regulatory and market-driven changes in practices relating to the payment of incentive compensation to brokers and other producers, including changes that have been announced and those which may occur in the future; the possibility of unfavorable loss development; the incidence and severity of catastrophes, both natural and man-made; stronger than anticipated competitive activity; unfavorable judicial or legislative developments; the potential effect of domestic and foreign regulatory developments, including those which could increase the Company's business costs and required capital levels; the possibility of general economic and business conditions that are less favorable than anticipated; the Company's ability to distribute its products through distribution channels, both current and future; the uncertain effects of emerging claim and coverage issues; a downgrade in the Company's financial strength or credit ratings; the ability of the Company's subsidiaries to pay dividends to the Company; the Company's ability to adequately price its property and casualty policies; the ability to recover the Company's systems and information in the event of a disaster or other unanticipated event; potential for difficulties arising from outsourcing relationships; potential changes in Federal or State tax laws; and other factors described in such forward-looking statements.

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OVERVIEW

The Hartford is a diversified insurance and financial services company with operations dating back to 1810. The Company is headquartered in Connecticut and is organized into two major operations: Life and Property & Casualty, each containing reporting segments. Within the Life and Property & Casualty operations, The Hartford conducts business principally in ten operating segments. Additionally, Corporate primarily includes the Company's debt financing and related interest expense, as well as certain capital raising activities and purchase accounting adjustments.

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Life is organized into six reportable operating segments: Retail Products Group (Retail), Retirement Plans, Institutional Solutions Group (Institutional), Individual Life, Group Benefits and International. Through Life the Company provides retail and institutional investment products such as variable and fixed annuities, mutual funds, private placement life insurance and retirement plan services, individual life insurance products including variable universal life, universal life, interest sensitive whole life and term life; and group benefit products, such as group life and group disability insurance.

Property & Casualty is organized into four reportable operating segments: the underwriting segments of Business Insurance, Personal Lines and Specialty Commercial (collectively Ongoing Operations), and the Other Operations segment. Through Property & Casualty the Company provides a number of coverages, as well as insurance-related services, to businesses throughout the United States, including workers compensation, property, automobile, liability, umbrella, specialty casualty, marine, livestock, fidelity and surety, professional liability and director s and officer s liability coverages. Property & Casualty also provides automobile, homeowners, and home-based business coverage to individuals throughout the United States, as well as insurance-related services to businesses.

Many of the principal factors that drive the profitability of The Hartford s Life and Property & Casualty operations are separate and distinct. Management considers this diversification to be a strength of The Hartford that distinguishes the Company from many of its peers. To present its operations in a more meaningful and organized way, management has included separate overviews within the Life and Property & Casualty sections of MD&A. For further overview of Life s profitability and analysis, see page 51. For further overview of Property & Casualty s profitability and analysis, see page 70.

Broker Compensation

As the Company has disclosed previously, the Company pays brokers and independent agents commissions and other forms of incentive compensation in connection with the sale of many of the Company s insurance products. Since the New York Attorney General s Office filed a civil complaint against Marsh on October 14, 2004, several of the largest national insurance brokers, including Marsh, Aon Corporation and Willis Group Holdings Limited, have announced that they have discontinued the use of contingent compensation arrangements. Other industry participants may make similar, or different, determinations in the future. In addition, legal, legislative, regulatory, business or other developments may require changes to industry practices relating to incentive compensation.

Pursuant to settlement agreements reached with regulators, several insurance companies have agreed to restrictions on the payment of contingent compensation relating to the placement of excess casualty insurance policies. These insurers have agreed that the restrictions may be extended in time, and to other property and casualty lines, if insurers in a given line or segment, that together represent more than 65% of the market share in the insurance line (based upon national gross written premiums), do not pay contingent compensation. On November 30, 2006, the New York Attorney General s Office notified these insurers that the 65% threshold had been reached for a number of insurance lines, including personal automobile and homeowners insurance. As a result, beginning January 1, 2007, these insurers were prohibited from paying contingent compensation relating to the placement of these types of insurance. In addition, on December 21, 2006, Chubb Corporation agreed to forego the payment of contingent compensation for all P&C insurance lines pursuant to a settlement agreement reached with regulators. These insurers, including Chubb, have also agreed to support legislation and regulations to abolish contingent compensation and to require greater disclosure of compensation. At this time, it is not possible to predict the effect of these announced or potential future changes on our business or distribution strategies, but such changes could have a material adverse effect on us in the future.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America (GAAP), requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company has identified the following estimates as critical in that they involve a higher degree of judgment and are subject to a significant degree of variability: property and casualty reserves for unpaid losses and loss adjustment

expenses, net of reinsurance; Life deferred policy acquisition costs and present value of future profits associated with variable annuity and other universal life-type contracts; the evaluation of other-than-temporary impairments on investments in available-for-sale securities; the valuation of guaranteed minimum withdrawal benefit derivatives; pension and other postretirement benefit obligations; and contingencies relating to corporate litigation and regulatory matters. In developing these estimates management makes subjective and complex judgments that are inherently uncertain and subject to material change as facts and circumstances develop. Although variability is inherent in these estimates, management believes the amounts provided are appropriate based upon the facts available upon compilation of the financial statements.

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Property & Casualty Reserves, Net of Reinsurance

The Hartford establishes property and casualty reserves to provide for the estimated costs of paying claims under insurance policies written by the Company. These reserves include estimates for both claims that have been reported and those that have been incurred but not reported, and include estimates of all expenses associated with processing and settling these claims. Estimating the ultimate cost of future losses and loss adjustment expenses is an uncertain and complex process. This estimation process is based largely on the assumption that past developments are an appropriate predictor of future events and involves a variety of actuarial techniques that analyze experience, trends and other relevant factors. Reserve estimates can change over time because of unexpected changes in the external environment. Potential external factors include (1) changes in the inflation rate for goods and services related to covered damages such as medical care, hospital care, auto parts, wages and home repair, (2) changes in the general economic environment that could cause unanticipated changes in the claim frequency per unit insured, (3) changes in the litigation environment as evidenced by changes in claimant attorney representation in the claims negotiation and settlement process, (4) changes in the judicial environment regarding the interpretation of policy provisions relating to the determination of coverage and/or the amount of damages awarded for certain types of damages, (5) changes in the social environment regarding the general attitude of juries in the determination of liability and damages, (6) changes in the legislative environment regarding the definition of damages and (7) new types of injuries caused by new types of injurious exposure: past examples include breast implants, lead paint and construction defects. Reserve estimates can also change over time because of changes in internal company operations. Potential internal factors include (1) periodic changes in claims handling procedures, (2) growth in new lines of business where exposure and loss development patterns are not well established or (3) changes in the quality of risk selection in the underwriting process. In the case of assumed reinsurance, all of the above risks apply. In addition, changes in ceding company case reserving and reporting patterns can create additional factors that need to be considered in estimating the reserves. Due to the inherent complexity of the assumptions used, final claim settlements may vary significantly from the present estimates, particularly when those settlements may not occur until well into the future.

Through both facultative and treaty reinsurance agreements, the Company cedes a share of the risks it has underwritten to other insurance companies. The Company's net reserves for loss and loss adjustment expenses include anticipated recovery from reinsurers on unpaid claims. The estimated amount of the anticipated recovery, or reinsurance recoverable, is net of an allowance for uncollectible reinsurance.

Reinsurance recoverables include an estimate of the amount of gross loss and loss adjustment expense reserves that may be ceded under the terms of the reinsurance agreements, including incurred but not reported unpaid losses. The Company calculates its ceded reinsurance projection based on the terms of any applicable facultative and treaty reinsurance, including an estimate of how incurred but not reported losses will ultimately be ceded by reinsurance agreement. Accordingly, the Company's estimate of reinsurance recoverables is subject to similar risks and uncertainties as the estimate of the gross reserve for unpaid losses and loss adjustment expenses.

The Company provides an allowance for uncollectible reinsurance, reflecting management's best estimate of reinsurance cessions that may be uncollectible in the future due to reinsurers' unwillingness or inability to pay. The Company analyzes recent developments in commutation activity between reinsurers and cedants, recent trends in arbitration and litigation outcomes in disputes between reinsurers and cedants and the overall credit quality of the Company's reinsurers. Where its contracts permit, the Company secures future claim obligations with various forms of collateral, including irrevocable letters of credit, secured trusts, funds held accounts and group-wide offsets. The allowance for uncollectible reinsurance was \$412 as of December 31, 2006, including \$294 related to Other Operations and \$118 related to Ongoing Operations.

Due to the inherent uncertainties as to collection and the length of time before reinsurance recoverables become due, it is possible that future adjustments to the Company's reinsurance recoverables, net of the allowance, could be required, which could have a material adverse effect on the Company's consolidated results of operations or cash flows in a particular quarter or annual period.

The Hartford, like other insurance companies, categorizes and tracks its insurance reserves for its segments by line of business, such as property, auto physical damage, auto liability, commercial multi-peril package business, workers compensation, general liability professional liability and fidelity and surety. Furthermore, The Hartford regularly

reviews the appropriateness of reserve levels at the line of business level, taking into consideration the variety of trends that impact the ultimate settlement of claims for the subsets of claims in each particular line of business. In addition, within the Other Operations segment, the Company has reserves for asbestos and environmental (A&E) claims. Adjustments to previously established reserves, which may be material, are reflected in the operating results of the period in which the adjustment is determined to be necessary. In the judgment of management, information currently available has been properly considered in the reserves established for losses and loss adjustment expenses. Incurred but not reported (IBNR) reserves represent the difference between the estimated ultimate cost of all claims and the actual reported loss and loss adjustment expenses (reported losses). Reported losses represent cumulative loss and loss adjustment expenses paid plus case reserves for outstanding reported claims. Company actuaries evaluate the total reserves (IBNR and case reserves) on an accident year basis. An accident year is the calendar year in which a loss is incurred, or, in the case of claims-made policies, the calendar year in which a loss is reported.

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The following table shows loss and loss adjustment expense reserves by line of business and by operating segment as of December 31, 2006, net of reinsurance:

	Business Insurance	Personal Lines	Specialty Commercial	Other Operations	Total P&C
Reserve Line of Business					
Property	\$ 65	\$ 225	\$ 63	\$	\$ 353
Auto physical damage	15	26	9		50
Auto liability	625	1,526	94		2,245
Package business	2,028				2,028
Workers compensation	3,816	7	1,830		5,653
General liability	587	39	1,504		2,130
Professional liability			556		556
Fidelity and surety			158		158
Assumed Reinsurance [1]				813	813
All other non-A&E				1,045	1,045
A&E	8	2	5	2,558	2,573
Total reserves-net	7,144	1,825	4,219	4,416	17,604
Reinsurance and other recoverables	650	134	2,303	1,300	4,387
Total reserves-gross	\$ 7,794	\$ 1,959	\$ 6,522	\$ 5,716	\$ 21,991

[1] These net loss and loss adjustment expense reserves relate to assumed reinsurance underwritten by Reinsurance operations that were moved into Other Operations (formerly known as HartRe).

Reserving for non-A&E reserves within Ongoing and Other Operations*How non-A&E reserves are set*

Reserves are set by line of business within the various operating segments. As indicated in the above table, a single line of business may be written in one or more of the segments. Case reserves are established by a claims handler on each individual claim and are adjusted as new information becomes known during the course of handling the claim. Lines of business for which loss data (e.g., paid losses and case reserves) emerge (i.e., is reported) over a long period of time are referred to as long-tail lines of business. Lines of business for which loss data emerge more quickly are referred to as short-tail lines of business. Within the Company's Ongoing Operations the shortest-tail lines of business are property and auto physical damage. The longest tail lines of business within Ongoing Operations include workers

compensation, general liability, and professional liability. Assumed reinsurance, which is within Other Operations, is also long-tail business.

For short-tail lines of business, emergence of paid loss and case reserves is credible and likely indicative of ultimate losses. For long-tail lines of business, emergence of paid losses and case reserves is less credible in the early periods and, accordingly may not be indicative of ultimate losses.

An expected loss ratio is used in initially recording the reserves for both short-tail and long-tail lines of business. This expected loss ratio is determined through a review of prior accident years' loss ratios and expected changes to earned pricing, loss costs, mix of business, ceded reinsurance and other factors that are expected to impact the loss ratio for the current accident year. For short-tail lines, IBNR for the current accident year is initially recorded as the product of the expected loss ratio for the period, earned premium for the period and the proportion of losses expected to be reported in future calendar periods for the current accident period. For long-tailed lines, IBNR reserves for the current accident year are initially recorded as the product of the expected loss ratio for the period and the earned premium for the period, less reported losses for the period.

Company reserving actuaries, who are independent of the business units, regularly review reserves for both current and prior accident years using the most current claim data. These reserve reviews incorporate a variety of actuarial methods and judgments and involve rigorous analysis. Most non-A&E reserves are reviewed fully each quarter, including loss reserves for property, auto physical damage, auto liability, package business, workers' compensation, most general liability, professional liability and fidelity and surety. Other non-A&E reserves are reviewed semi-annually (twice per year) or annually. These include, but are not limited to, reserves for allocated loss adjustment expenses, assumed reinsurance, latent exposures such as construction defects, unallocated loss adjustment expense and all other non-A&E exposures within Other Operations. For reserves that are reviewed semi-annually and annually, management monitors the emergence of paid and reported losses in the intervening quarters to either confirm that its estimate of ultimate losses should not change or, if necessary, perform a reserve review to determine whether the reserve estimate should change.

For most lines of business, a variety of actuarial methods are reviewed and the actuaries select methods and specific assumptions appropriate for each line of business based on the current circumstances affecting that line of business. These selections incorporate input, as judged by the reserving actuaries to be appropriate, from claims personnel, pricing actuaries and operating management on

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reported loss cost trends and other factors that could affect the reserve estimates. The output of the reserve reviews are reserve estimates that are referred to herein as the actuarial indication .

The actuarial techniques or methods used include paid and reported loss development, frequency / severity, expected loss ratio and Bornhuetter-Ferguson techniques. Within any one line of business, a variety of techniques are used. Within any one line of business, certain methods are generally given more influence in determining the actuarial indication. The methods that are given more influence vary within a line of business based primarily on the maturity of the accident year, the mix of business and the particular internal and external influences impacting the claims experience or the methods. The following is a discussion of the most common methods used; these methods are not used for every line of business or every accident year within a line of business.

Paid Development method. Historical data, organized by accident period and calendar period, is used to develop paid loss development patterns, which are then applied to current paid losses by accident period to estimate ultimate losses. The paid development method is also used to estimate reserves for allocated loss adjustments expenses (ALAE). Paid development techniques do not use information about case reserves and, therefore, are not affected by changes in case reserving practices. Paid development techniques can, however, be significantly affected by changes in claim closure patterns. Paid development techniques for longer-tailed lines are generally less useful for more recent accident years since a low percentage of ultimate losses are paid to date in early periods of development and small changes in paid losses can have a large impact on estimated ultimate losses.

Reported Development method. Historical data, organized by accident period and calendar period, is used to develop reported loss development patterns, which are then applied to current reported losses by accident period to estimate ultimate losses. The reported losses used in this analysis refer to cumulative paid losses plus case reserves and do not include IBNR.

Compared to the paid development technique, the reported development technique has the advantage that a higher percentage of ultimate losses are reflected in reported losses than in cumulative paid losses. The reported development technique estimates only the unreported losses rather than the total unpaid losses. While the reported development technique takes advantage of information contained in the case reserves, estimates determined from this technique are affected by changes in case reserving practices.

Both paid and reported development techniques assume that historical development patterns are predictive of future development patterns.

Frequency / Severity methods. Historical data is used to develop claim count development patterns and those patterns are applied to the number of current reported claims to estimate ultimate claim counts. Estimated ultimate claim counts are multiplied by an estimated average severity (i.e., an average cost per claim) to calculate estimated ultimate losses. Average severity is estimated by fitting historical severity data to a trend line and making assumptions about how the current environment would affect claim severity. In making assumptions about the current environment, industry data is used where such data is available and appropriate.

The advantage of frequency / severity techniques is that frequency estimates are generally easier to predict and external information can be used to supplement internal data in making severity estimates.

Expected Loss Ratio method. Loss ratios for prior accident years are used to determine the appropriate expected loss ratio for the current accident year after applying anticipated changes in rates, pricing and loss costs. The current accident year expected loss ratio is multiplied by earned premium to calculate estimated ultimate losses. Expected Loss Ratio techniques are useful for early periods of maturity on long-tailed lines of business, where very little paid or reported loss information is available.

Bornhuetter-Ferguson method. This method is a combination of the expected loss ratio method and the reported development method, where the reported loss development method is given more weight as an accident year matures. For all lines of business, variations of the above methods are used. Examples of variation within the paid and reported development methods include:

- The accident period used may vary (e.g., year, quarter, or month)

- The Company may analyze the data by coverage (e.g., bodily injury separate from property damage)

- There may be adjustments for unusual loss activity

- For ALAE, the Company uses patterns of the relationship between paid ALAE and paid losses.

Examples of variation within the frequency /severity methods include:

For one sub-set of professional liability business, management estimates frequency, not through historical claim count development, but through an analysis of the securities class actions filed and policy listings

For some methods, management projects severity on only open claims

In the commercial liability lines, the Company performs the frequency / severity technique only on claims over a certain size

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For allocated loss adjustment expenses (ALAE), the Company analyzes ALAE on claims in suit and associated legal expenses separately from ALAE on other claims.

For each line of business, certain methods are given more influence than other methods. The discussion below gives a general indication of which methods are preferred by line of business. Because the actuarial estimates are generated at a much finer level of detail than line of business (e.g., by distribution channel, coverage, accident period), this description should not be assumed to apply to each coverage and accident year within a line of business. Also, as circumstances change, the methods that are given more influence will change. For example, for Personal Lines auto liability claims, reported development techniques are currently not given significant influence in making estimates for recent accident years because case reserving practices have been changing in the recent past. If case reserving practices become more stable, reported development techniques may be given more weight.

Property and Auto Physical Damage. These lines are fast-developing and paid and reported development techniques are used. The Company performs and relies primarily on reported development techniques and frequency/severity and Bornhuetter-Ferguson techniques for the most immature accident months.

Auto Liability Personal Lines. For auto liability, and bodily injury in particular, the Company performs a greater number of techniques than it does for property and auto physical damage, including paid and reported development, and several frequency / severity approaches. The Company generally uses the reported development method for older accident years and the frequency / severity methods for more recent accident years. Recent periods are heavily influenced by changes in case reserve practices and changing disposal rates, and the frequency / severity techniques are not affected as much by these changes.

Auto Liability Commercial Lines, Package Business and Short-Tailed General Liability. As with Personal Lines auto liability, the Company performs a variety of techniques, including the paid and reported development methods and frequency / severity techniques. For older, more mature accident years, management finds that reported development techniques are best. For more recent accident years, management typically prefers frequency / severity techniques that allow it to make assumptions about the frequency of larger claims.

Long-Tailed General Liability, Fidelity and Surety and Large Deductible Workers Compensation. For these very long-tailed lines of business, the Company generally relies on the expected loss ratio, Bornhuetter-Ferguson and reported development techniques. Management generally weights these techniques together, relying more heavily on the expected loss ratio method at early ages of development and more on the reported development method as an accident year matures.

Workers Compensation. Workers compensation is the Company's single largest reserve line of business and management does the largest amount of actuarial analysis on this line of business. Methods performed include paid and reported development, variations on expected loss ratio methods, and an in-depth analysis on the largest states. Paid development patterns are historically very stable in the Company's workers compensation business, so paid techniques are preferred for older accident periods. For more recent periods, paid techniques are less predictive of the ultimate liability since such a low percentage of ultimate losses are paid in early periods of development. Accordingly, for more recent accident periods, the Company generally relies more heavily on a state-by-state analysis and the expected loss ratio approach.

Professional Liability. Reported and paid loss developments patterns for this line tend to be volatile. Therefore, the Company typically relies on frequency and severity techniques.

Assumed Reinsurance and All Other within Other Operations. For these lines, management tends to rely on the reported development techniques. In assumed reinsurance, assumptions are influenced by information gained from claim and underwriting audits.

Allocated Loss Adjustment Expenses (ALAE). For some lines of business (e.g., professional liability and assumed reinsurance), ALAE and losses are analyzed together. For most lines of business, however, ALAE is analyzed separately, using paid development and frequency / severity techniques.

The final step in the reserve review process involves a comprehensive review by senior reserving actuaries who apply their judgment and, in concert with senior management, determine the appropriate level of reserves based on the various information that has been accumulated. Numerous factors are considered in this determination process including, but not limited to, the assessed reliability of key loss trends and assumptions that may be significantly influencing the current actuarial indications, the maturity of the accident year, pertinent trends observed over the

recent past, the level of volatility within a particular line of business, and the improvement or deterioration of actuarial indications in the current period as compared to the prior periods. In general, changes are made more quickly to more mature accident years and less volatile lines of business. At year-end 2006, total recorded net reserves excluding asbestos and environmental and excluding the allowance for uncollectible reinsurance were 2.2% higher than the actuarial indication of the reserves. Annually, as part of the statutory reporting requirements, IBNR is allocated to accident year by statutory line of business. This work forms the basis for the loss development table and reserve re-estimates table shown in the Business section.

During 2006, there were numerous changes to non-A&E reserve estimates. Among other loss developments in 2006, these changes included an \$83 reduction in catastrophe reserves related to the 2005 and 2004 hurricanes, a \$58 release of Business Insurance allocated

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loss adjustment expense reserves for workers' compensation and package business related to accident years 2003 to 2005, and a \$45 strengthening of Specialty Commercial construction defect claim reserves for accident years 1997 and prior. See Reserves within the Property and Casualty MD&A for further discussion of reserve developments.

Current trends contributing to reserve uncertainty

The Hartford is a multi-line company in the property and casualty business. The Hartford is therefore subject to reserve uncertainty stemming from a number of conditions, including but not limited to those noted above, any of which could be material at any point in time for any segment. Certain issues may become more or less important over time as conditions change. As various market conditions develop, management must assess whether those conditions constitute a long-term trend that should result in a reserving action (i.e., increasing or decreasing the reserve).

Within the commercial segments and the Other Operations segment, the Company has exposure to claims asserted for bodily injury as a result of long-term or continuous exposure to harmful products or substances. Examples include, but are not limited to, pharmaceutical products, latex gloves, silica and lead paint. The Company also has exposure to claims from construction defects, where property damage or bodily injury from negligent construction is alleged. The Company also has exposure to claims asserted against religious institutions and other organizations relating to molestation or abuse. Such exposures may involve potentially long latency periods and may implicate coverage in multiple policy periods. These factors make reserves for such claims more uncertain than other bodily injury or property damage claims. With regard to these exposures, the Company is monitoring trends in litigation, the external environment, the similarities to other mass torts and the potential impact on the Company's reserves.

In Personal Lines, reserving estimates are generally less variable than for the Company's other property and casualty segments. This is largely due to the coverages having relatively shorter periods of loss emergence. Estimates, however, can still vary due to a number of factors, including interpretations of frequency and severity trends and their impact on recorded reserve levels. Severity trends can be impacted by changes in internal claim handling and case reserving practices in addition to changes in the external environment. These changes in claim practices increase the uncertainty in the interpretation of case reserve data, which increases the uncertainty in recorded reserve levels. In addition, the success of the Company's new Dimensions class plan for automobile first introduced in 2004 has led to a different mix of business by type of insured than the Company experienced in the past. In general, the Company now has a lower proportion of preferred risks than in the past. Such a change in mix increases the uncertainty of the reserve projections, since historical data and reporting patterns may not be applicable to the new business.

In Business Insurance, workers' compensation is the Company's single biggest line of business and the line of business with the longest pattern of loss emergence. Reserve estimates for workers' compensation are particularly sensitive to assumptions about medical inflation and the changing use of medical care procedures. In addition, changes in state legislative and regulatory environments impact the Company's estimates. These changes increase the uncertainty in the application of development patterns.

In the Specialty Commercial segment, many lines of insurance, such as excess insurance and large deductible workers compensation insurance are long-tail lines of insurance. For long-tail lines, the period of time between the incidence of the insured loss and either the reporting of the claim to the insurer, the settlement of the claim, or the payment of the claim can be substantial, and in some cases, several years. As a result of this extended period of time for losses to emerge, reserve estimates for these lines are more uncertain (i.e. more variable) than reserve estimates for shorter-tail lines of insurance. Estimating required reserve levels for large deductible workers' compensation insurance is further complicated by the uncertainty of whether losses that are attributable to the deductible amount can be paid by the insured; if such losses are not paid by the insured due to financial difficulties, the Company would be contractually liable. Another example of reserve variability relates to reserves for directors and officers insurance. There is uncertainty in the required level of reserves due to the impact of recent allegations within the financial services industry, including those in the mutual fund, investment banking and insurance industries.

Impact of changes in key assumptions on reserve volatility

As stated above, the Company's practice is to estimate reserves using a variety of methods, assumptions and data elements. Within its reserve estimation process for reserves other than asbestos and environmental, the Company does not derive statistical loss distributions or confidence levels around its reserve estimate and, as a result, does not have reserve range estimates to disclose.

The reserve estimation process includes explicit assumptions about a number of factors in the internal and external environment. Across most lines of business, the most important assumptions are future loss development factors applied to paid or reported losses to date. For most lines, the reported loss development factor is most important. In workers' compensation, paid loss development factors are also important. The trend in loss costs is also a key assumption, particularly in the most recent accident years, where loss development factors are less credible. The following discussion includes disclosure of possible variation from current estimates of loss reserves due to a change in certain key assumptions. Each of the impacts described below is estimated individually, without consideration for any correlation among key assumptions or among lines of business. Therefore, it would be inappropriate to take each of the amounts described below and add them together in an attempt to estimate volatility for the Company's reserves in total. The estimated variation in reserves due to changes

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in key assumptions is a reasonable estimate of possible variation that may occur in the future, likely over a period of several calendar years. It is important to note that the variation discussed is not meant to be a worst-case scenario, and therefore, it is possible that future variation may be more than the amounts discussed below.

Recorded reserves for workers' compensation, net of reinsurance, are \$5.7 billion across Business Insurance and Specialty Commercial. The two most important assumptions for workers' compensation reserves are loss development factors and loss cost trends, particularly medical cost inflation. Loss development patterns are dependent on medical cost inflation. Approximately half of the workers' compensation net reserves are related to future medical costs. A review of National Council on Compensation Insurance (NCCI) data suggests that the annual growth in industry medical claim costs has varied from -2% to +12% since 1991. This data shows that medical inflation has been highly variable over the past decade. Across the entire workers' compensation reserve base, a 1 point change in calendar year medical inflation would change the estimated net reserve by \$600, in either direction.

Recorded reserves for auto liability, net of reinsurance, are \$2.2 billion across all lines, \$1.5 billion of which is in Personal Lines. Personal auto liability reserves are shorter-tailed than other lines of business (such as workers compensation) and, therefore, less volatile. However, the size of the reserve base means that future changes in estimates could be material to the Company's results of operations in any given period. The key assumption for Personal Lines auto liability is the annual loss cost trend, particularly the severity trend component of loss costs. A review of Insurance Services Office (ISO) data suggests that annual growth in industry severity since 1999 has varied from +1% to +6%. The ISO data shows recent severity changes to be in the middle of this range. A 2.5 point change in assumed annual severity is within historical variation for the industry and for the Company. A 2.5 point change in assumed annual severity for the two most recent accident years would change the estimated net reserve need by \$70, in either direction. Assumed annual severity for accident years prior to the two most recent accident years is likely to have minimal variability.

Recorded reserves for general liability, net of reinsurance, are \$2.1 billion across Business Insurance and Specialty Commercial. Reported loss development patterns are a key assumption for this line of business, particularly for more mature accident years. Historically, assumptions on reported loss development patterns have been impacted by, among other things, emergence of new types of claims (e.g. construction defect claims) or a shift in the mixture between smaller, more routine claims and larger, more complex claims. The Company has reviewed the historical variation in reported loss development patterns. If the reported loss development patterns change by 10%, a change that is within historical variation, the estimated net reserve need would change by \$300, in either direction. A 10% change in reported loss development patterns is within historical variation, as measured by the variation around the average development factors as reported in statutory accident year reports.

Similar to general liability, assumed casualty reinsurance is affected by reported loss development pattern assumptions. In addition to the items identified above that would affect both direct and reinsurance liability claim development patterns, there is also an impact to assumed reporting patterns for any changes in claim notification from ceding companies to the reinsurer. Recorded net reserves for HartRe assumed reinsurance business, excluding asbestos and environmental liabilities, within Other Operations were \$813 as of December 31, 2006. If the reported loss development patterns underlying the Company's net reserves for HartRe assumed casualty reinsurance change by 10%, the estimated net reserve need would change by \$254, in either direction. A 10% change in reported loss development patterns is within historical variation, as measured by the variation around the average development factors as reported in statutory accident year reports.

Reserving for Asbestos and Environmental Claims within Other Operations

How A&E reserves are set

The Company continues to receive asbestos and environmental claims. Asbestos claims relate primarily to bodily injuries asserted by people who came in contact with asbestos or products containing asbestos. Environmental claims relate primarily to pollution and related clean-up costs.

The Company wrote several different categories of insurance contracts that may cover asbestos and environmental claims. First, the Company wrote primary policies providing the first layer of coverage in an insured's liability program. Second, the Company wrote excess policies providing higher layers of coverage for losses that exhaust the limits of underlying coverage. Third, the Company acted as a reinsurer assuming a portion of those risks assumed by

other insurers writing primary, excess and reinsurance coverages. Fourth, subsidiaries of the Company participated in the London Market, writing both direct insurance and assumed reinsurance business.

In establishing reserves for asbestos claims, the Company evaluates its insureds' estimated liabilities for such claims using a ground-up approach. The Company considers a variety of factors, including the jurisdictions where underlying claims have been brought, past, pending and anticipated future claim activity, disease mix, past settlement values of similar claims, dismissal rates, allocated loss adjustment expense, and potential bankruptcy impact.

Similarly, a ground-up exposure review approach is used to establish environmental reserves. The Company's evaluation of its insureds' estimated liabilities for environmental claims involves consideration of several factors, including historical values of similar claims, the number of sites involved, the insureds' alleged activities at each site, the alleged environmental damage at each site, the

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respective shares of liability of potentially responsible parties at each site, the appropriateness and cost of remediation at each site, the nature of governmental enforcement activities at each site, and potential bankruptcy impact.

Having evaluated its insureds' probable liabilities for asbestos and/or environmental claims, the Company then evaluates its insureds' insurance coverage programs for such claims. The Company considers its insureds' total available insurance coverage, including the coverage issued by the Company. The Company also considers relevant judicial interpretations of policy language and applicable coverage defenses or determinations, if any.

Evaluation of both the insureds' estimated liabilities and the Company's exposure to the insureds depends heavily on an analysis of the relevant legal issues and litigation environment. This analysis is conducted by the Company's lawyers and is subject to applicable privileges.

For both asbestos and environmental reserves, the Company also compares its historical direct net loss and expense paid and incurred experience, and net loss and expense paid and incurred experience year by year, to assess any emerging trends, fluctuations or characteristics suggested by the aggregate paid and incurred activity.

Once the gross ultimate exposure for indemnity and allocated loss adjustment expense is determined for its insureds by each policy year, the Company calculates its ceded reinsurance projection based on any applicable facultative and treaty reinsurance and the Company's experience with reinsurance collections.

Uncertainties Regarding Adequacy of Asbestos and Environmental Reserves

With regard to both environmental and particularly asbestos claims, significant uncertainty limits the ability of insurers and reinsurers to estimate the ultimate reserves necessary for unpaid losses and related expenses. Traditional actuarial reserving techniques cannot reasonably estimate the ultimate cost of these claims, particularly during periods where theories of law are in flux. The degree of variability of reserve estimates for these exposures is significantly greater than for other more traditional exposures. In particular, the Company believes there is a high degree of uncertainty inherent in the estimation of asbestos loss reserves.

In the case of the reserves for asbestos exposures, factors contributing to the high degree of uncertainty include inadequate loss development patterns, plaintiffs' expanding theories of liability, the risks inherent in major litigation, and inconsistent emerging legal doctrines. Furthermore, over time, insurers, including the Company, have experienced significant changes in the rate at which asbestos claims are brought, the claims experience of particular insureds, and the value of claims, making predictions of future exposure from past experience uncertain. Plaintiffs and insureds also have sought to use bankruptcy proceedings, including pre-packaged bankruptcies, to accelerate and increase loss payments by insurers. In addition, some policyholders have asserted new classes of claims for coverages to which an aggregate limit of liability may not apply. Further uncertainties include insolvencies of other carriers and unanticipated developments pertaining to the Company's ability to recover reinsurance for asbestos and environmental claims. Management believes these issues are not likely to be resolved in the near future.

In the case of the reserves for environmental exposures, factors contributing to the high degree of uncertainty include expanding theories of liability and damages; the risks inherent in major litigation; inconsistent decisions concerning the existence and scope of coverage for environmental claims; and uncertainty as to the monetary amount being sought by the claimant from the insured.

It is also not possible to predict changes in the legal and legislative environment and their effect on the future development of asbestos and environmental claims. It is unknown whether potential Federal asbestos-related legislation will be enacted or what its effect would be on the Company's aggregate asbestos liabilities.

The reporting pattern for assumed reinsurance claims, including those related to asbestos and environmental claims is much longer than for direct claims. In many instances, it takes months or years to determine that the policyholder's own obligations have been met and how the reinsurance in question may apply to such claims. The delay in reporting reinsurance claims and exposures adds to the uncertainty of estimating the related reserves.

Given the factors described above, the Company believes the actuarial tools and other techniques it employs to estimate the ultimate cost of claims for more traditional kinds of insurance exposure are less precise in estimating reserves for its asbestos and environmental exposures. For this reason, the Company relies on exposure-based analysis to estimate the ultimate costs of these claims and regularly evaluates new information in assessing its potential asbestos and environmental exposures.

A number of factors affect the variability of estimates for asbestos and environmental reserves including assumptions with respect to the frequency of claims, the average severity of those claims settled with payment, the dismissal rate of claims with no payment and the expense to indemnity ratio. The uncertainty with respect to the underlying reserve assumptions for asbestos and environmental adds a greater degree of variability to these reserve estimates than reserve estimates for more traditional exposures. While this variability is reflected in part in the size of the range of reserves developed by the Company, that range may still not be indicative of the potential variance between the ultimate outcome and the recorded reserves. The recorded net reserves as of December 31, 2006 of \$2.57 billion (\$2.25 billion and \$322 for asbestos and environmental, respectively) is within an estimated range, unadjusted for covariance, of \$1.99 billion to \$3.05 billion. The process of estimating asbestos and environmental reserves remains subject to a wide variety of

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uncertainties, which are detailed in Note 12 of Notes to Consolidated Financial Statements. Due to these uncertainties, further developments could cause the Company to change its estimates and ranges of its asbestos and environmental reserves, and the effect of these changes could be material to the Company's consolidated operating results, financial condition and liquidity.

Total Property & Casualty Reserves, Net of Reinsurance

In the opinion of management, based upon the known facts and current law, the reserves recorded for the Company's property and casualty businesses at December 31, 2006 represent the Company's best estimate of its ultimate liability for losses and loss adjustment expenses related to losses covered by policies written by the Company. However, because of the significant uncertainties surrounding reserves, and particularly asbestos exposures, it is possible that management's estimate of the ultimate liabilities for these claims may change and that the required adjustment to recorded reserves could exceed the currently recorded reserves by an amount that could be material to the Company's results of operations, financial condition and liquidity.

Life Deferred Policy Acquisition Costs and Present Value of Future Profits Associated with Variable Annuity and Other Universal Life-Type Contracts

Accounting Policy and Assumptions

Life policy acquisition costs include commissions and certain other expenses that vary with and are primarily associated with acquiring business. Present value of future profits (PVFP) is an intangible asset recorded upon applying purchase accounting in an acquisition of a life insurance company. Deferred policy acquisition costs and the present value of future profits intangible asset are amortized in the same way. Both are amortized over the estimated life of the contracts acquired. Within the following discussion, deferred policy acquisition costs and the present value of future profits intangible asset will be referred to as DAC. At December 31, 2006 and December 31, 2005, the carrying value of the Company's Life DAC asset was \$9.1 billion and \$8.6 billion, respectively. Of those amounts, \$4.4 billion and \$4.5 billion related to individual variable annuities sold in the U.S., \$1.4 billion and \$1.2 billion related to individual variable annuities sold in Japan and \$2.1 billion and \$1.9 billion related to universal life-type contracts sold by Individual Life.

The Company amortizes DAC related to investment contracts and universal life-type contracts (including individual variable annuities) using the retrospective deposit method. Under the retrospective deposit method, acquisition costs are amortized in proportion to the present value of estimated gross profits (EGPs). EGPs are also used to amortize other assets and liabilities on the Company's balance sheet, such as sales inducement assets and unearned revenue reserves. Components of EGPs are used to determine reserves for guaranteed minimum death and income benefits. For most contracts, the Company evaluates EGPs over a 20 year horizon as estimated profits emerging subsequent to year 20 are immaterial. The Company uses other measures for amortizing DAC, such as gross costs (net of reinsurance), as a replacement for EGPs when EGPs are expected to be negative for multiple years of the contract's life. The Company also adjusts the DAC balance, through other comprehensive income, by an amount that represents the amortization of DAC that would have been required as a charge or credit to operations had unrealized gains and losses on investments been realized. Actual gross profits, in a given reporting period, that vary from management's initial estimates result in increases or decreases in the rate of amortization, commonly referred to as a true-up, which are reco-align:left;font-size:10pt;">

\$
945,015

Due between one and two years
1,224,030

1,221,301

Due between two and three years

744,427

741,925

Due after three years

359,567

358,951

Total

\$

3,273,369

\$

3,267,192

We review our debt and marketable equity securities classified as short-term investments on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. We consider factors such as the length of time and extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer and our intent to sell, or whether it is more likely than not we will be required to sell the investment before recovery of the investment's amortized cost basis. If we believe that an other-than-temporary decline exists in one of these securities, we write down these investments to fair value. For debt securities, the portion of the write-down related to credit loss would be recorded to interest and other income, net in our Condensed Consolidated Statements of Income. Any portion not related to credit loss would be recorded to accumulated other comprehensive income, which is reflected as a separate component of stockholders' equity in our Condensed Consolidated Balance Sheets. For equity securities, the write-down would be recorded to investment gains (losses), net in our Condensed Consolidated Statements of Income. During the three months ended March 4, 2016, we did not consider any of our investments to be other-than-temporarily impaired.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4. FAIR VALUE MEASUREMENTS

Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis

We measure certain financial assets and liabilities at fair value on a recurring basis. There have been no transfers between fair value measurement levels during the three months ended March 4, 2016.

The fair value of our financial assets and liabilities at March 4, 2016 was determined using the following inputs (in thousands):

	Total	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents:				
Money market mutual funds	399,846	399,846	—	—
Time deposits	7,509	7,509	—	—
Short-term investments:				
Asset-backed securities	92,171	—	92,171	—
Corporate bonds and commercial paper	2,027,076	—	2,027,076	—
Foreign government securities	1,275	—	1,275	—
Municipal securities	141,558	—	141,558	—
U.S. agency securities	111,451	—	111,451	—
U.S. Treasury securities	893,661	—	893,661	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	13,500	—	13,500	—
Other assets:				
Deferred compensation plan assets	37,660	1,052	36,608	—
Interest rate swap derivatives	29,019	—	29,019	—
Total assets	\$3,754,726	\$408,407	\$3,346,319	\$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	\$1,600	\$—	\$1,600	\$—
Total liabilities	\$1,600	\$—	\$1,600	\$—

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The fair value of our financial assets and liabilities at November 27, 2015 was determined using the following inputs (in thousands):

	Total	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents:				
Money market mutual funds	\$482,479	\$482,479	\$—	\$—
Municipal securities	1,849	—	1,849	—
Time deposits	13,461	13,461	—	—
U.S. Treasury securities	26,400	—	26,400	—
Short-term investments:				
Asset-backed securities	83,314	—	83,314	—
Corporate bonds and commercial paper	1,886,914	—	1,886,914	—
Foreign government securities	1,268	—	1,268	—
Municipal securities	137,332	—	137,332	—
U.S. agency securities	130,468	—	130,468	—
U.S. Treasury securities	872,228	—	872,228	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	19,126	—	19,126	—
Other assets:				
Deferred compensation plan assets	32,063	971	31,092	—
Interest rate swap derivatives	19,821	—	19,821	—
Total assets	\$3,706,723	\$496,911	\$3,209,812	\$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	\$2,154	\$—	\$2,154	\$—
Total liabilities	\$2,154	\$—	\$2,154	\$—

See Note 3 for further information regarding the fair value of our financial instruments.

Our fixed income available-for-sale securities consist of high quality, investment grade securities from diverse issuers with a minimum credit rating of BBB- and a weighted average credit rating of AA-. We value these securities based on pricing from pricing vendors who may use quoted prices in active markets for identical assets (Level 1 inputs) or inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs) in determining fair value. However, we classify all of our fixed income available-for-sale securities as having Level 2 inputs. The valuation techniques used to measure the fair value of our financial instruments and derivatives having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques. Our procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources.

Our deferred compensation plan assets consist of prime money market funds and mutual funds.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We also have direct investments in privately held companies accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. If we determine that an other-than-temporary impairment has occurred, we write down the investment to its fair value. We estimate fair value of our cost method investments considering available information such as pricing in recent rounds of financing, current cash positions, earnings and cash flow forecasts, recent operational performance and any other readily available market data. For the three months ended March 4, 2016 we determined there was an immaterial other-than-temporary impairment on certain of our cost method investments and wrote down the investments to fair value. For the three months ended February 27, 2015, we determined there were no other-than-temporary impairments on our cost method investments.

As of March 4, 2016, the carrying value of our lease receivables approximated fair value, based on Level 2 valuation inputs which include Treasury rates, London Interbank Offered Rate ("LIBOR") interest rates and applicable credit spreads. See Note 11 for further details regarding our investment in lease receivable.

The fair value of our senior notes was \$1.99 billion as of March 4, 2016, based on observable market prices in less active markets and categorized as Level 2. See Note 12 for further details regarding our debt.

NOTE 5. DERIVATIVES AND HEDGING ACTIVITIES

Hedge Accounting and Hedging Programs

We recognize all derivative instruments as either assets or liabilities in our Condensed Consolidated Balance Sheets and measure them at fair value. Gains and losses resulting from changes in fair value are accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting.

We evaluate hedge effectiveness at the inception of the hedge prospectively as well as retrospectively, and record any ineffective portion of the hedging instruments in interest and other income (expense), net on our Condensed Consolidated Statements of Income. The time value of purchased contracts is recorded in interest and other income (expense), net in our Condensed Consolidated Statements of Income.

The bank counterparties to these contracts expose us to credit-related losses in the event of their nonperformance which are largely mitigated with collateral security agreements that provide for collateral to be received or posted when the net fair value of certain financial instruments fluctuates from contractually established thresholds. In addition, the Company enters into master netting arrangements which have the ability to further limit credit-related losses with the same counterparty by permitting net settlement of transactions. Our hedging policy also establishes maximum limits for each counterparty to mitigate any concentration of risk.

Balance Sheet Hedging—Hedges of Foreign Currency Assets and Liabilities

We hedge our net recognized foreign currency denominated assets and liabilities with foreign exchange forward contracts to reduce the risk that the value of these assets and liabilities will be adversely affected by changes in exchange rates. These contracts hedge assets and liabilities that are denominated in foreign currencies and are carried at fair value with changes in the fair value recorded to interest and other income (expense), net in our Condensed Consolidated Statements of Income. These contracts do not subject us to material balance sheet risk due to exchange rate movements because gains and losses on these derivatives are intended to offset gains and losses on the assets and liabilities being hedged.

Cash Flow Hedging—Hedges of Forecasted Foreign Currency Revenue and Interest Rate Risk

In countries outside the United States, we transact business in U.S. Dollars and in various other currencies. We may use foreign exchange option contracts or forward contracts to hedge certain cash flow exposures resulting from changes in these foreign currency exchange rates. These foreign exchange contracts, carried at fair value, have maturities of up to twelve months. We enter into these foreign exchange contracts to hedge a portion of our forecasted foreign currency denominated revenue in the normal course of business and accordingly, they are not speculative in nature.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

To receive hedge accounting treatment, all hedging relationships are formally documented at the inception of the hedge, and the hedges must be highly effective in offsetting changes to future cash flows on hedged transactions. We record changes in the intrinsic value of these cash flow hedges in accumulated other comprehensive income in our Condensed Consolidated Balance Sheets, until the forecasted transaction occurs. When the forecasted transaction occurs, we reclassify the related gain or loss on the cash flow hedge to revenue. In the event the underlying forecasted transaction does not occur, or it becomes probable that it will not occur, we reclassify the gain or loss on the related cash flow hedge from accumulated other comprehensive income to interest and other income (expense), net in our Condensed Consolidated Statements of Income at that time. If we do not elect hedge accounting, or the contract does not qualify for hedge accounting treatment, the changes in fair value from period to period are recorded in interest and other income (expense), net in our Condensed Consolidated Statements of Income.

In December 2014, prior to issuing new long-term fixed rate debt, we entered into an interest rate lock agreement on a notional amount of \$600 million to hedge against the variability of future interest payments due to changes in the benchmark interest rate. This instrument was designated as a cash flow hedge. Upon issuance of our \$1 billion of 3.25% senior notes due February 1, 2025 (the “2025 Notes”) in January 2015, we terminated the instrument and incurred a loss of \$16.2 million. This loss is recorded in the stockholders’ equity section in our Condensed Consolidated Balance Sheets in accumulated other comprehensive income and will be reclassified to interest expense over a ten-year term consistent with the impact of the hedged item. See Note 12 for further details regarding our debt.

Fair Value Hedging - Hedges of Interest Rate Risk

During the third quarter of fiscal 2014, we entered into interest rate swaps designated as fair value hedges related to our \$900 million of 4.75% fixed interest rate senior notes due February 1, 2020 (the “2020 Notes”). In effect, the interest rate swaps convert the fixed interest rate on our 2020 Notes to a floating interest rate based on LIBOR. Under the terms of the swaps, we will pay monthly interest at the one-month LIBOR interest rate plus a fixed number of basis points on the \$900 million notional amount through February 1, 2020. In exchange, we will receive 4.75% fixed rate interest from the swap counterparties. See Note 12 for further details regarding our debt.

The interest rate swaps are accounted for as fair value hedges and substantially offset the changes in fair value of the hedged portion of the underlying debt that are attributable to the changes in market risk. Therefore, the gains and losses related to changes in the fair value of the interest rate swaps are included in interest and other income (expense), net in our Condensed Consolidated Statement of Income. The fair value of the interest rate swaps is reflected as either an asset or liability in our Condensed Consolidated Balance Sheets.

The fair value of derivative instruments on our Condensed Consolidated Balance Sheets as of March 4, 2016 and November 27, 2015 were as follows (in thousands):

	2016		2015	
	Fair Value	Fair Value	Fair Value	Fair Value
	Asset	Liability	Asset	Liability
	Derivatives	Derivatives	Derivatives	Derivatives
Derivatives designated as hedging instruments:				
Foreign exchange option contracts ^{(1) (3)}	\$11,986	\$—	\$16,979	\$—
Interest rate swap ⁽²⁾	29,019	—	19,821	—
Derivatives not designated as hedging instruments:				

Foreign exchange forward contracts ⁽¹⁾	1,514	1,600	2,147	2,154
Total derivatives	\$42,519	\$1,600	\$38,947	\$2,154

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(1) Included in prepaid expenses and other current assets and accrued expenses for asset derivatives and liability derivatives, respectively, on our Condensed Consolidated Balance Sheets.

(2) Included in other assets or other liabilities on our Condensed Consolidated Balance Sheets.

(3) Hedging effectiveness expected to be recognized into income within the next twelve months.

The effect of foreign currency derivative instruments designated as cash flow hedges and of foreign currency derivative instruments not designated as hedges in our Condensed Consolidated Statements of Income for the three months ended March 4, 2016 and February 27, 2015 was as follows (in thousands):

	2016		2015	
	Foreign	Foreign	Foreign	Foreign
	Exchange	Exchange	Exchange	Exchange
	Option	Forward	Option	Forward
	Contracts	Contracts	Contracts	Contracts
Derivatives in cash flow hedging relationships:				
Net gain (loss) recognized in OCI, net of tax ⁽¹⁾	\$(1,711) \$—	\$22,239	\$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax ⁽²⁾	\$3,220	\$—	\$23,712	\$—
Net gain (loss) recognized in income ⁽³⁾	\$(5,140) \$—	\$(2,935) \$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income ⁽⁴⁾	\$—	\$(965) \$—	\$2,070

(1) Net change in the fair value of the effective portion classified in other comprehensive income ("OCI").

(2) Effective portion classified as revenue.

(3) Ineffective portion and amount excluded from effectiveness testing classified in interest and other income (expense), net.

(4) Classified in interest and other income (expense), net.

NOTE 6. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Goodwill as of March 4, 2016 and November 27, 2015 was \$5.39 billion and \$5.37 billion, respectively.

Purchased and other intangible assets subject to amortization as of March 4, 2016 and November 27, 2015 were as follows (in thousands):

	2016		2015	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
		Net		Net
Purchased technology	\$199,662	\$(113,047)	\$199,053	\$(104,704)
Customer contracts and relationships	\$551,008	\$(224,024)	\$506,639	\$(204,578)
Trademarks	81,256	(43,921)	81,219	(41,175)
Acquired rights to use technology	145,083	(105,408)	144,202	(100,278)
Localization	904	(358)	1,500	(358)
Other intangibles	37,481	(9,950)	36,280	(7,793)
Total other intangible assets	\$815,732	\$(383,661)	\$769,840	\$(354,182)

Purchased and other intangible assets, net	\$1,015,394	\$ (496,708)	\$518,686	\$968,893	\$ (458,886)	\$510,007
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Amortization expense related to purchased and other intangible assets was \$37.6 million and \$39.5 million for the three months ended March 4, 2016 and February 27, 2015, respectively. Of these amounts \$19.0 million and \$24.9 million were included in cost of sales for the three months ended March 4, 2016 and February 27, 2015, respectively.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of March 4, 2016, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2016	\$22,405	\$85,073
2017	23,568	103,535
2018	16,441	92,171
2019	10,074	65,345
2020	7,865	35,220
Thereafter	6,262	50,727
Total expected amortization expense	\$86,615	\$432,071

NOTE 7. ACCRUED EXPENSES

Accrued expenses as of March 4, 2016 and November 27, 2015 consisted of the following (in thousands):

	2016	2015
Accrued compensation and benefits	\$251,250	\$312,776
Sales and marketing allowances	57,569	66,876
Accrued corporate marketing	47,117	38,512
Taxes payable	29,405	27,996
Royalties payable	19,040	23,334
Accrued interest expense	7,335	26,538
Other	180,105	183,852
Accrued expenses	\$591,821	\$679,884

Other primarily includes general corporate accruals including accrued restructuring charges, and local and regional expenses. Other is also comprised of deferred rent related to office locations with rent escalations and foreign currency liability derivatives.

NOTE 8. STOCK-BASED COMPENSATION

Summary of Restricted Stock Units

Restricted stock unit activity for the three months ended March 4, 2016 and the fiscal year ended November 27, 2015 was as follows (in thousands):

	2016	2015
Beginning outstanding balance	10,069	13,564
Awarded	3,325	4,012
Released	(4,288)	(6,561)
Forfeited	(255)	(946)
Ending outstanding balance	8,851	10,069

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Information regarding restricted stock units outstanding at March 4, 2016 and February 27, 2015 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2016			
Restricted stock units outstanding	8,851	1.52	\$762.7
Restricted stock units vested and expected to vest	7,716	1.45	\$654.2
2015			
Restricted stock units outstanding	11,002	1.39	\$870.2
Restricted stock units vested and expected to vest	9,557	1.33	\$746.7

The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ (*) Global Select Market, the market values as of March 4, 2016 and February 27, 2015 were \$86.18 and \$79.10, respectively.

Summary of Performance Shares

Our 2016, 2015 and 2014 Performance Share Programs aim to help focus key employees on building stockholder value, provide significant award potential for achieving outstanding Company performance and enhance the ability of the Company to attract and retain highly talented and competent individuals. The Executive Compensation Committee of our Board of Directors approves the terms of each of our Performance Share Programs, including the award calculation methodology, under the terms of our 2003 Equity Incentive Plan. Shares may be earned based on the achievement of an objective relative total stockholder return measured over a three-year performance period. Performance share awards will be awarded and fully vest upon the Executive Compensation Committee's certification of the level of achievement following the three-year anniversary of each grant date. Program participants generally have the ability to receive up to 200% of the target number of shares originally granted.

In the first quarter of fiscal 2016, the Executive Compensation Committee approved the 2016 Performance Share Program, the terms of which are similar to prior year performance share programs as discussed above.

In the first quarter of fiscal 2016, the Executive Compensation Committee also certified the actual performance achievement of participants in the 2013 Performance Share Program. Actual performance resulted in participants achieving 198% of target or approximately 1.4 million shares. The shares granted and achieved under the 2013 Performance Share Program fully vested on the third-year anniversary of the grant on January 24, 2016, if not forfeited. As of March 4, 2016, the shares awarded under our 2016, 2015 and 2014 Performance Share Programs are yet to be achieved.

The following table sets forth the summary of performance share activity under our Performance Share Programs for the three months ended March 4, 2016 and the fiscal year ended November 27, 2015 (in thousands):

2016		2015	
Shares	Maximum	Shares	Maximum
Granted	Shares Eligible	Granted	Shares Eligible

			to Receive		to Receive
Beginning outstanding balance	1,940		3,881	1,517	3,034
Achieved	(1,373)	(1,387) —	—
Awarded	1,206	(1)	1,053	671	1,342
Forfeited	(50)	(101) (248) (495
Ending outstanding balance	1,723		3,446	1,940	3,881

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Included in the 1.2 million shares awarded during the three months ended March 4, 2016 were 0.7 million shares (1) awarded for the final achievement of the 2013 Performance Share program. The remaining awarded shares were for the 2016 Performance Share Program.

Summary of Employee Stock Purchase Plan Shares

The expected life of the ESPP shares is the average of the remaining purchase periods under each offering period. The assumptions used to value employee stock purchase rights during the three months ended March 4, 2016 and February 27, 2015 were as follows:

	Three Months	
	2016	2015
Expected life (in years)	0.5 - 2.0	0.5 - 2.0
Volatility	27% - 29%	27% - 30%
Risk free interest rate	0.49% - 1.06%	0.12% - 0.67%

Employees purchased 0.7 million shares at an average price of \$58.79 and 0.7 million shares at an average price of \$50.31 for the three months ended March 4, 2016 and February 27, 2015, respectively. The intrinsic value of shares purchased during the three months ended March 4, 2016 and February 27, 2015 was \$23.7 million and \$16.0 million, respectively. The intrinsic value is calculated as the difference between the market value on the date of purchase and the purchase price of the shares.

Summary of Stock Options

The Executive Compensation Committee of Adobe's Board of Directors eliminated the use of stock option grants for all employees and the Board of Directors effective fiscal 2012 and fiscal 2014, respectively. As of March 4, 2016 and November 27, 2015, we had 1.1 million and 3.2 million stock options outstanding, respectively.

Compensation Costs

As of March 4, 2016, there was \$623.3 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock-based awards which will be recognized over a weighted average period of 2.2 years. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Total stock-based compensation costs included in our Condensed Consolidated Statements of Income for the three months ended March 4, 2016 and February 27, 2015 were as follows (in thousands):

Income Statement Classifications	2016		2015	
	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards
Cost of revenue—subscription	\$373	\$1,803	\$441	\$1,529
Cost of revenue—services and support	1,433	1,895	1,216	1,857
Research and development	3,874	29,484	4,056	26,705
Sales and marketing	4,550	29,356	4,598	27,285
General and administrative	1,233	18,747	1,463	16,761

Total	\$11,463	\$81,285	\$11,774	\$74,137
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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9. STOCKHOLDERS' EQUITY

Retained Earnings

The changes in retained earnings for the three months ended March 4, 2016 were as follows (in thousands):

Balance as of November 27, 2015	\$7,253,431
Net income	254,307
Re-issuance of treasury stock	(286,655)
Balance as of March 4, 2016	\$7,221,083

We account for treasury stock under the cost method. When treasury stock is re-issued at a price higher than its cost, the difference is recorded as a component of additional paid-in-capital in our Condensed Consolidated Balance Sheets. When treasury stock is re-issued at a price lower than its cost, the difference is recorded as a component of additional paid-in-capital to the extent that there are treasury stock gains to offset the losses. If there are no treasury stock gains in additional paid-in-capital, the losses upon re-issuance of treasury stock are recorded as a reduction of retained earnings in our Condensed Consolidated Balance Sheets.

The components of accumulated other comprehensive income (loss) and activity, net of related taxes, as of March 4, 2016 were as follows (in thousands):

	November 27, 2015	Increase / Decrease	Reclassification Adjustments	March 4, 2016
Net unrealized gains on available-for-sale securities:				
Unrealized gains on available-for-sale securities	\$ 2,542	\$ 727	\$ (333)	\$ 2,936
Unrealized losses on available-for-sale securities	(7,095)	(2,354)	289	(9,160)
Total net unrealized gains on available-for-sale securities	(4,553)	(1,627)	(44) ⁽¹⁾	(6,224)
Net unrealized gains / losses on derivative instruments designated as hedging instruments	2,915	(1,711)	(2,935) ⁽²⁾	(1,731)
Cumulative foreign currency translation adjustments	(167,442)	23,718	—	(143,724)
Total accumulated other comprehensive income (loss), net of taxes	\$ (169,080)	\$ 20,380	\$ (2,979)	\$ (151,679)

(1) Reclassification adjustments for gains / losses on available-for-sale securities are classified in interest and other income (expense), net.

(2) Reclassification adjustments for loss on the interest rate lock agreement and gains / losses on other derivative instruments are classified in interest and other income (expense), net and revenue, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table sets forth the taxes related to each component of other comprehensive income (loss) for the three months ended March 4, 2016 and February 27, 2015 (in thousands):

	Three Months	
	2016	2015
Available-for-sale securities:		
Unrealized gains / losses	\$28	\$(107)
Reclassification adjustments	—	—
Subtotal available-for-sale securities	28	(107)
Derivatives designated as hedging instruments:		
Unrealized gains / losses on derivative instruments ⁽¹⁾	—	6,147
Reclassification adjustments ⁽¹⁾	(151)	(53)
Subtotal derivatives designated as hedging instruments	(151)	6,094
Foreign currency translation adjustments	633	(2,095)
Total taxes, other comprehensive income (loss)	\$510	\$3,892

(1) Taxes related to derivative instruments other than the interest rate lock agreement were zero based on the tax jurisdiction where these derivative instruments were executed.

Stock Repurchase Program

To facilitate our stock repurchase program, designed to return value to our stockholders and minimize dilution from stock issuances, we may repurchase shares in the open market or enter into structured repurchase agreements with third parties. In the first quarter of fiscal 2015, the Board of Directors approved a new stock repurchase program granting the Company authority to repurchase up to \$2 billion in common stock through the end of fiscal 2017. During the three months ended March 4, 2016 and February 27, 2015, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling \$150 million and \$200 million, respectively. The prepayment of \$150 million during the three months ended March 4, 2016 was under the current \$2 billion authority while the prepayment of \$200 million during the three months ended February 27, 2015 was under the previous \$2 billion authority. We enter into these agreements in order to take advantage of repurchasing shares at a guaranteed discount to the Volume Weighted Average Price ("VWAP") of our common stock over a specified period of time. We only enter into such transactions when the discount that we receive is higher than the foregone return on our cash prepayments to the financial institutions. There were no explicit commissions or fees on these structured repurchases. Under the terms of the agreements, there is no requirement for the financial institutions to return any portion of the prepayment to us.

The financial institutions agree to deliver shares to us at monthly intervals during the contract term. The parameters used to calculate the number of shares deliverable are: the total notional amount of the contract, the number of trading days in the contract, the number of trading days in the interval and the average VWAP of our stock during the interval less the agreed upon discount. During the three months ended March 4, 2016, we repurchased approximately 1.5 million shares at an average price of \$88.67 through structured repurchase agreements entered into during fiscal 2015 and the three months ended March 4, 2016. During the three months ended February 27, 2015, we repurchased approximately 2.4 million shares at an average price of \$72.39 through structured repurchase agreements entered into during fiscal 2014 and the three months ended February 27, 2015.

For the three months ended March 4, 2016, the prepayments were classified as treasury stock on our Condensed Consolidated Balance Sheets at the payment date, though only shares physically delivered to us by March 4, 2016 were excluded from the computation of earnings per share. As of March 4, 2016, \$54.8 million of prepayment

remained under this agreement.

Subsequent to March 4, 2016, as part of our \$2 billion stock repurchase program, we entered into a structured stock repurchase agreement with a large financial institution whereupon we provided them with a prepayment of \$225 million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the \$225 million stock repurchase agreement, \$1.2 billion remains under our current authority.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the three months ended March 4, 2016 and February 27, 2015 (in thousands, except per share data):

	Three Months	
	2016	2015
Net income	\$254,307	\$84,888
Shares used to compute basic net income per share	499,125	498,754
Dilutive potential common shares:		
Unvested restricted stock and performance share awards	5,922	7,479
Stock options	629	1,293
Shares used to compute diluted net income per share	505,676	507,526
Basic net income per share	\$0.51	\$0.17
Diluted net income per share	\$0.50	\$0.17

For the three months ended March 4, 2016 and February 27, 2015, there were no options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of \$87.98 and \$73.38, respectively that would have been anti-dilutive.

NOTE 11. COMMITMENTS AND CONTINGENCIES

Lease Commitments

We occupy three office buildings in San Jose, California where our corporate headquarters are located. We reference these office buildings as the Almaden Tower and the East and West Towers. We own the East and West Tower buildings, lease the Almaden Tower building and own the land under each of them.

The lease agreement for the Almaden Tower is effective through March 2017. We are the investors in the lease receivable related to the Almaden Tower lease in the amount of \$80.4 million, which is recorded as investment in lease receivable on our Condensed Consolidated Balance Sheets. As of March 4, 2016, the carrying value of the lease receivable related to the Almaden Tower approximated fair value. Under the agreement for the Almaden Tower, we have the option to purchase the building at any time during the lease term for \$103.6 million. If we purchase the building, the investment in the lease receivables may be credited against the purchase price. The residual value guarantee under the Almaden Tower obligation is \$89.4 million.

The Almaden Tower lease is subject to standard covenants including certain financial ratios that are reported to the lessor quarterly. As of March 4, 2016, we were in compliance with all of the covenants. In the case of a default, the lessor may demand we purchase the building for an amount equal to the lease balance, or require that we remarket or relinquish the building. If we choose to remarket or are required to do so upon relinquishing the building, we are bound to arrange the sale of the building to an unrelated party and will be required to pay the lessor any shortfall between the net remarketing proceeds and the lease balance, up to the residual value guarantee amount less our investment in lease receivable. The Almaden Tower lease qualifies for operating lease accounting treatment and, as such, the building and the related obligation are not included in our Condensed Consolidated Balance Sheets.

Royalties

We have royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit sold or a percentage of the underlying revenue.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Indemnifications

In the ordinary course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products and from time to time, we are subject to claims by our customers under these indemnification provisions. Historically, costs related to these indemnification provisions have not been significant and we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

To the extent permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is or was serving at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that reduces our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

Legal Proceedings

In connection with disputes relating to the validity or alleged infringement of third-party intellectual property rights, including patent rights, we have been, are currently and may in the future be subject to claims, negotiations or complex, protracted litigation. Intellectual property disputes and litigation may be very costly and can be disruptive to our business operations by diverting the attention and energies of management and key technical personnel. Although we have successfully defended or resolved past litigation and disputes, we may not prevail in any ongoing or future litigation and disputes. Third-party intellectual property disputes could subject us to significant liabilities, require us to enter into royalty and licensing arrangements on unfavorable terms, prevent us from licensing certain of our products or offering certain of our services, subject us to injunctions restricting our sale of products or services, cause severe disruptions to our operations or the markets in which we compete, or require us to satisfy indemnification commitments with our customers including contractual provisions under various license arrangements and service agreements.

In addition to intellectual property disputes, we are subject to legal proceedings, claims and investigations in the ordinary course of business, including claims relating to commercial, employment and other matters. Some of these disputes and legal proceedings may include speculative claims for substantial or indeterminate amounts of damages. We consider all claims on a quarterly basis in accordance with GAAP and based on known facts assess whether potential losses are considered reasonably possible, probable and estimable. Based upon this assessment, we then evaluate disclosure requirements and whether to accrue for such claims in our financial statements. This determination is then reviewed and discussed with our Audit Committee and our independent registered public accounting firm. We make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case. Unless otherwise specifically disclosed in this note, we have determined that no provision for liability nor disclosure is required related to any claim against us because: (a) there is not a reasonable possibility that a loss exceeding amounts already recognized (if any) may be incurred with respect to such claim; (b) a reasonably possible loss or range of loss cannot be estimated; or (c) such estimate is immaterial.

All legal costs associated with litigation are expensed as incurred. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against us. It is possible, nevertheless, that our consolidated financial position, cash flows or results of operations could be negatively affected by an unfavorable resolution of one or more of such proceedings, claims or investigations.

In connection with our anti-piracy efforts, conducted both internally and through organizations such as the Business Software Alliance, from time to time we undertake litigation against alleged copyright infringers. Such lawsuits may lead to counter-claims alleging improper use of litigation or violation of other laws. We believe we have valid defenses with respect to such counter-claims; however, it is possible that our consolidated financial position, cash flows or results of operations could be negatively affected in any particular period by the resolution of one or more of these counter-claims.

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NOTE 12. DEBT

Notes

In February 2010, we issued \$600 million of 3.25% senior notes due February 1, 2015 (the “2015 Notes”) and \$900 million of 4.75% senior notes due February 1, 2020 (the “2020 Notes”). Our proceeds were \$1.5 billion and were net of an issuance discount of \$6.6 million. In addition, we incurred issuance costs of \$10.7 million. Both the discount and issuance costs were or are being amortized to interest expense over the respective terms of the 2015 and 2020 Notes using the effective interest method. The 2015 Notes ranked, and 2020 Notes rank, equally with our other unsecured and unsubordinated indebtedness. The effective interest rate including the discount and issuance costs was 3.45% for the 2015 Notes and is 4.92% for the 2020 Notes. Interest is payable semi-annually, in arrears, on February 1 and August 1, and commenced on August 1, 2010. The 2015 Notes were settled on February 1, 2015, as discussed below. In June 2014, we entered into interest rate swaps with a total notional amount of \$900 million designated as a fair value hedge related to our 2020 Notes. The interest rate swaps effectively convert the fixed interest rate on our 2020 Notes to a floating interest rate based on LIBOR plus a fixed number of basis points. Under the terms of the swap, we will pay monthly interest at the one-month LIBOR floating interest rate plus a spread of a fixed number of basis points on the \$900 million notional amount. In exchange, we will receive 4.75% fixed rate interest from the swap counterparties. See Note 5 for further details regarding our interest rate swap derivatives.

In December 2014, prior to issuing new long-term fixed rate debt, we entered into an interest rate lock agreement on a notional amount of \$600 million to hedge against the variability of future interest payments due to changes in the benchmark interest rate. This instrument was designated as a cash flow hedge. See Note 5 for further details regarding our interest rate lock agreement.

In January 2015, we issued \$1 billion of 3.25% senior notes due February 1, 2025 (the “2025 Notes”). Our proceeds were approximately \$989.3 million which is net of an issuance discount of \$10.7 million. In addition, we incurred issuance costs of \$7.9 million. Both the discount and issuance costs are being amortized to interest expense over the term of the 2025 Notes using the effective interest method. The 2025 Notes rank equally with our other unsecured and unsubordinated indebtedness. The effective interest rate including the discount, issuance costs and interest rate agreement is 3.67% for the 2025 Notes. Interest is payable semi-annually, in arrears on February 1 and August 1, commencing on August 1, 2015. A portion of the proceeds from this offering was used to repay \$600 million in aggregate principal amount of the 2015 Notes plus accrued and unpaid interest due February 1, 2015. The remaining proceeds were used for general corporate purposes.

As of March 4, 2016, our outstanding notes payable consists of the 2020 Notes and 2025 Notes (the “Notes”) with a total carrying value of \$1.92 billion. Based on quoted prices in inactive markets, the fair value of the Notes was \$1.99 billion as of March 4, 2016. The total fair value of \$1.99 billion excludes the effect of fair value hedge of the 2020 Notes for which we entered into interest rate swaps as described above.

We may redeem the Notes at any time, subject to a make-whole premium. In addition, upon the occurrence of certain change of control triggering events, we may be required to repurchase the Notes, at a price equal to 101% of their principal amount, plus accrued and unpaid interest to the date of repurchase. The Notes also include covenants that limit our ability to grant liens on assets and to enter into sale and leaseback transactions, subject to significant allowances. As of March 4, 2016, we were in compliance with all of the covenants.

In February 2016, we made semi-annual interest payments on our 2020 and 2025 Notes totaling \$37.6 million.

Credit Agreement

On March 2, 2012, we entered into a five-year \$1 billion senior unsecured revolving credit agreement (the “Credit Agreement”), providing for loans to us and certain of our subsidiaries. Pursuant to the terms of the Credit Agreement, we may, subject to the agreement of the applicable lenders, request up to an additional \$500 million in commitments, for a maximum aggregate commitment of \$1.5 billion. Loans under the Credit Agreement will bear interest at either (i) LIBOR plus a margin, based on our public debt ratings, ranging from 0.795% and 1.30% or (ii) the base rate, which is defined as the highest of (a) the agent’s prime rate, (b) the federal funds effective rate plus 0.50% or (c) LIBOR plus 1.00% plus a margin, based on our debt

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

ratings, ranging from 0.00% to 0.30%. Commitment fees are payable quarterly at rates between 0.08% and 0.20% per year, also based on our debt ratings. Subject to certain conditions stated in the Credit Agreement, we and any of our subsidiaries designated as additional borrowers may borrow, prepay and re-borrow amounts under the revolving credit facility at any time during the term of the Credit Agreement.

The Credit Agreement contains customary representations, warranties, affirmative and negative covenants, including a financial covenant, events of default and indemnification provisions in favor of the lenders. The negative covenants include restrictions regarding the incurrence of liens and indebtedness, certain merger and acquisition transactions, dispositions and other matters, all subject to certain exceptions. The financial covenant, based on a quarterly financial test, requires us not to exceed a maximum leverage ratio.

On March 1, 2013, we exercised an option under the Credit Agreement to extend the maturity date of the Credit Agreement by one year to March 2, 2018.

On July 27, 2015, we entered into an amendment to further extend the maturity date of the Credit Agreement to July 27, 2020 and reallocated the facility among the syndicate of lenders that are parties to the Credit Agreement.

The facility will terminate and all amounts owing thereunder will be due and payable on the maturity date unless (a) the commitments are terminated earlier upon the occurrence of certain events, including an event of default, or (b) the maturity date is further extended upon our request, subject to the agreement of the lenders.

As of March 4, 2016, there were no outstanding borrowings under this Credit Agreement and we were in compliance with all covenants.

NOTE 13. NON-OPERATING INCOME (EXPENSE)

Non-operating income (expense) for the three months ended March 4, 2016 and February 27, 2015 included the following (in thousands):

	Three Months	
	2016	2015
Interest and other income (expense), net:		
Interest income	\$ 10,677	\$ 6,288
Foreign exchange gains (losses)	(6,530)	(4,247)
Realized gains on fixed income investment	333	967
Realized losses on fixed income investment	(289)	(40)
Other	(4)	370
Interest and other income (expense), net	\$ 4,187	\$ 3,338
Interest expense	\$(18,469)	\$(14,545)
Investment gains (losses), net:		
Realized investment gains	\$ 1,055	\$ 1,695
Realized investment losses	(125)	—
Unrealized investment losses	(2,099)	(265)
Investment gains (losses), net	\$(1,169)	\$ 1,430
Non-operating income (expense), net	\$(15,451)	\$(9,777)

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14. SEGMENTS

We report segment information based on the “management” approach. The management approach designates the internal reporting used by management for making decisions and assessing performance as the source of our reportable segments.

Our CEO, the chief operating decision maker, reviews revenue and gross margin information for each of our reportable segments, but does not review operating expenses on a segment by segment basis. In addition, with the exception of goodwill and intangible assets, we do not identify or allocate our assets by the reportable segments. We have the following reportable segments:

Digital Media—Our Digital Media segment provides tools and solutions that enable individuals, small and medium businesses and enterprises to create, publish, promote and monetize their digital content anywhere. Our customers include traditional content creators, web application developers and digital media professionals, as well as their management in marketing departments and agencies, companies and publishers. Our customers also include knowledge workers who create, collaborate and distribute documents.

Digital Marketing—Our Digital Marketing segment provides solutions and services for how digital advertising and marketing are created, managed, executed, measured and optimized. Our customers include digital marketers, advertisers, publishers, merchandisers, web analysts, chief marketing officers, chief information officers and chief revenue officers.

Print and Publishing—Our Print and Publishing segment addresses market opportunities ranging from the diverse authoring and publishing needs of technical and business publishing to our legacy type and OEM printing businesses. Our segment results for the three months ended March 4, 2016 and February 27, 2015 were as follows (dollars in thousands):

	Digital Media	Digital Marketing	Print and Publishing	Total
Three months ended March 4, 2016				
Revenue	\$931,718	\$406,246	\$45,371	\$1,383,335
Cost of revenue	54,547	141,917	2,108	198,572
Gross profit	\$877,171	\$264,329	\$43,263	\$1,184,763
Gross profit as a percentage of revenue	94	% 65	% 95	% 86
Three months ended February 27, 2015				
Revenue	\$702,773	\$357,167	\$49,241	\$1,109,181
Cost of revenue	44,345	120,375	2,078	166,798
Gross profit	\$658,428	\$236,792	\$47,163	\$942,383
Gross profit as a percentage of revenue	94	% 66	% 96	% 85

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto.

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements, including statements regarding product plans, future growth, market opportunities, strategic initiatives, industry positioning, customer acquisition, the amount of recurring revenue and revenue growth. In addition, when used in this report, the words "will," "expects," "could," "would," "may," "anticipates," "intends," "plans," "believes," "seeks," "targets," "for," "looks to," "continues" and similar expressions, as well as statements regarding our focus for the future, are generally intended to identify forward-looking statements. Each of the forward-looking statements we make in this report involves risks and uncertainties that could cause actual results to differ materially from these forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled "Risk Factors" in Part II, Item 1A of this report. You should carefully review the risks described herein and in other documents we file from time to time with the U.S. Securities and Exchange Commission (the "SEC"), including our Annual Report on Form 10-K for fiscal 2015. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document, except as required by law.

BUSINESS OVERVIEW

Founded in 1982, Adobe Systems Incorporated is one of the largest and most diversified software companies in the world. We offer a line of products and services used by creative professionals, marketers, knowledge workers, application developers, enterprises and consumers for creating, managing, delivering, measuring, optimizing and engaging with compelling content and experiences across multiple operating systems, devices and media. We market and license our products and services directly to enterprise customers through our sales force and to end users through app stores and our own website at www.adobe.com. We offer many of our products via a Software-as-a-Service ("SaaS") model or a managed services model (both of which are referred to as a hosted or cloud-based model) as well as through term subscription and pay-per-use models. We also distribute certain products and services through a network of distributors, value-added resellers ("VARs"), systems integrators, independent software vendors ("ISVs"), retailers and original equipment manufacturers ("OEMs"). In addition, we license our technology to hardware manufacturers, software developers and service providers for use in their products and solutions. Our products run on personal and server-based computers, as well as on smartphones, tablets and other devices, depending on the product. We have operations in the Americas, Europe, Middle East and Africa ("EMEA") and Asia-Pacific ("APAC").

Adobe was originally incorporated in California in October 1983 and was reincorporated in Delaware in May 1997. We maintain executive offices and principal facilities at 345 Park Avenue, San Jose, California 95110-2704. Our telephone number is 408-536-6000 and our website is www.adobe.com. Investors can obtain copies of our SEC filings from this site free of charge, as well as from the SEC website at www.sec.gov. The information posted to our website is not incorporated into this Quarterly Report on Form 10-Q.

OPERATIONS OVERVIEW

For our first quarter of fiscal 2016, we reported strong financial results consistent with the continued execution of our long-term plans for our two strategic growth areas, Digital Media and Digital Marketing, while continuing to market and license a broad portfolio of products and solutions. Our first quarter of fiscal 2016 financial results benefited from an extra week in the quarter due to our 52/53 week financial calendar whereby fiscal 2016 is a 53-week year compared with fiscal 2015 which was a 52-week year.

In our Digital Media segment, we are a market leader with Adobe Creative Cloud, our subscription-based offering for creating and publishing content and applications. Creative Cloud delivers value through more frequent product updates, storage and access to user files stored in the cloud with syncing of files across users' machines, access to marketplace, social and community-based features with our Adobe Stock and Behance services, app creation

capabilities and lower entry point pricing for cost-sensitive customers.

We offer Creative Cloud for individuals, teams and enterprises, and we enable larger enterprise customers to acquire Creative Cloud desktop apps through Enterprise Term License Agreements (“ETLAs”). These Creative Cloud offerings address the multiple routes to market we use to license our creative software to targeted customers. Adoption of Creative Cloud has transformed our business model, and we continue to expect this to drive higher long-term revenue growth through an expansion of our customer base by acquiring new users through a lower cost of entry and delivery of additional features and value, as well as keeping existing

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customers current on our latest release. We have also built out a marketplace for Creative Cloud subscribers to enable the delivery and purchase of stock content in our new service called Adobe Stock. Overall, our strategy with Creative Cloud is designed to enable us to increase our revenue with users, attract more new customers, and shift our revenue to be more recurring and predictable as revenue is recognized ratably.

We continue to implement strategies that will accelerate awareness, consideration and purchase of subscriptions to our Creative Cloud offering. These strategies include increasing the value Creative Cloud users receive, such as offering new mobile applications, as well as targeted promotions and offers that attract past customers and potential users to try out and ultimately subscribe to Creative Cloud. Because of the shift towards Creative Cloud subscriptions and ETLAs, perpetual revenue for older Creative products has continued to decline, and revenue from perpetual licensing of these products was immaterial for the first quarter of fiscal 2016.

We are also a market leader with our Adobe Document Cloud offerings built around our Acrobat family of products, the Adobe Reader and a set of integrated cloud-based document services, including Adobe eSign. Adobe Acrobat provides reliable creation and exchange of electronic documents, regardless of platform or application source type. In the second quarter of fiscal 2015, we delivered the next generation of this offering called Adobe Document Cloud, which we believe enhances the way people manage critical documents at home, in the office and across devices. Adobe Document Cloud includes Adobe Acrobat DC and Adobe eSign, and a set of integrated services enables users to create, review, approve, sign and track documents whether on a desktop or mobile device. Adobe Acrobat DC, with a touch-enabled user interface, is licensed both through subscription and perpetual pricing.

Annualized Recurring Revenue (“ARR”) is currently our key performance metric to assess the health and trajectory of our overall Digital Media segment. ARR should be viewed independently of revenue, deferred revenue and unbilled deferred revenue as ARR is a performance metric and is not intended to be combined with any of these items. We adjust our reported ARR on an annual basis to reflect any material exchange rates changes. Our reported ARR results in the first quarter of fiscal 2016 are based on currency rates set at the start of fiscal 2016 and held constant throughout the year. We calculate ARR as follows:

	Annual Value of Creative Cloud Subscriptions and Services
	+
Creative ARR	Annual Digital Publishing Suite Contract Value
	+
	Annual Creative ETLA Contract Value
	Annual Value of Document Cloud Subscriptions and Services
Document Cloud ARR	+
	Annual Document Cloud ETLA Contract Value
	Creative ARR
Digital Media ARR	+
	Document Cloud ARR

Creative ARR exiting the first quarter of fiscal 2016 was \$2.74 billion, up from \$2.50 billion at the end of fiscal 2015. Document Cloud ARR exiting the first quarter fiscal 2016 was \$393.0 million, up from \$385.0 million at the end of fiscal 2015. Total Digital Media ARR grew to \$3.13 billion at the end of the first quarter of fiscal 2016, up from \$2.88 billion at the end of fiscal 2015.

Our success in driving growth in ARR has begun to positively affect our revenue growth. Creative revenue in the first quarter of fiscal 2016 was \$732.9 million, up from \$509.4 million in the first quarter of fiscal 2015 and representing 44% year-over-year growth. Document Cloud revenue in the first quarter of fiscal 2016 was \$198.8 million, up from \$193.4 million in the first quarter of fiscal 2015 and representing 3% year-over-year growth. Total Digital Media

segment revenue grew to \$931.7 million in first quarter of fiscal 2016, up from \$702.8 million in the first quarter of fiscal 2015 and representing 33% year-over-year growth.

We are a market leader in the fast-growing category addressed by our Digital Marketing segment. Our Digital Marketing business provides comprehensive solutions that include analytics, social marketing, targeting, media optimization, digital

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experience management, cross-channel campaign management, audience management, premium video delivery and monetization. We deliver these capabilities through our Adobe Marketing Cloud, an integrated offering enabling marketers to measure, personalize and optimize marketing campaigns and digital experiences across channels for optimal marketing performance. With its broad set of solutions, including Adobe Analytics, Adobe Target, Adobe Social, Adobe Media Optimizer, Adobe Experience Manager, Adobe Campaign, Adobe Audience Manager and Adobe Primetime, as well as real-time dashboards and a collaborative interface, customers of Adobe Marketing Cloud are able to combine data, insights and digital content to deliver a personalized, relevant experience to their constituents.

In addition to chief marketing officers and digital marketers, users of our Adobe Marketing Cloud solutions include marketing professionals such as search engine marketers, media managers, media buyers and marketing research analysts. Customers also include web content editors, web analysts and web marketing managers. These customers often are involved in workflows that utilize other Adobe products, such as our Digital Media offerings and our video workflow and delivery technologies. By combining the creativity of our Digital Media business with the science of our Digital Marketing business, we help our customers to more efficiently and effectively make, manage, measure and monetize their content across every channel with an end-to-end workflow and feedback loop.

We utilize a direct salesforce to market and license our Adobe Marketing Cloud solutions, as well as an extensive ecosystem of partners including marketing agencies, systems integrators and developers that help license and deploy our solutions to their customers. We have made significant investments to broaden the scale and size of all of these routes to market, and our recent financial results reflect the success of these investments. In the first quarter of fiscal 2016, we achieved record Marketing Cloud revenue of \$377.3 million, which represents 21% year-over-year revenue growth. In addition, we drove strong demand for our Marketing Cloud solutions, which we expect will positively benefit revenue growth in future quarters.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing our Condensed Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and pursuant to the rules and regulations of the SEC, we make assumptions, judgments and estimates that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis, we evaluate our assumptions, judgments and estimates. We also discuss our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition, business combinations, goodwill impairment and income taxes have the greatest potential impact on our Condensed Consolidated Financial Statements. These areas are key components of our results of operations and are based on complex rules requiring us to make judgments and estimates, so we consider these to be our critical accounting policies. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results.

There have been no significant changes in our critical accounting policies and estimates during the three months ended March 4, 2016, as compared to the critical accounting policies and estimates disclosed in Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended November 27, 2015.

Recent Accounting Pronouncements Not Yet Effective

On May 28, 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of

either the retrospective or cumulative effect transition method. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date, which deferred the effective date of the new revenue standard for periods beginning after December 15, 2016 to December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of fiscal 2019. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

On February 24, 2016, the FASB issued ASU No. 2016-02, Leases, requiring lessees to recognize a right-of-use asset and a lease liability on the balance sheet for all leases with the exception of short-term leases. For lessees, leases will continue to be classified as either operating or finance leases in the income statement. Lessor accounting is similar to the current model but updated to align with certain changes to the lessee model. Lessors will continue to classify leases as operating, direct financing or

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sales-type leases. The effective date of the new standard for public companies is for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition and requires application of the new guidance at the beginning of the earliest comparative period presented. The updated standard is effective for us beginning in the first quarter of fiscal 2020. We are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

With the exception of the new standards discussed above, there have been no other recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 4, 2016, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended November 27, 2015, that are of significance or potential significance to us.

RESULTS OF OPERATIONS

Financial Performance Summary for the First Quarter of Fiscal 2016

Our results of operations for the first quarter of fiscal 2016 were impacted by an extra week due to our first quarter of fiscal 2016 having 14 weeks as compared to 13 weeks in the year-ago period.

During the three months ended March 4, 2016, our subscription revenue as a percentage of total revenue increased to 77% compared to 64% in the year-ago period as we transitioned more of our business to a subscription-based model.

Total Digital Media ARR of approximately \$3.13 billion as of March 4, 2016 increased by \$249 million, or 9%, from \$2.88 billion as of November 27, 2015. The change in our Digital Media ARR is primarily due to increases in the number of paid Creative Cloud and Document Cloud subscriptions.

Digital Media revenue of \$931.7 million during the three months ended March 4, 2016 increased by \$228.9 million, or 33%, compared with the year-ago period primarily due to the increase in subscription revenue associated with our Creative Cloud offering.

- Adobe Marketing Cloud revenue of \$377.3 million during the three months ended March 4, 2016 increased by \$65.9 million, or 21%, compared with the year-ago period. The increase was primarily due to continued adoption of our Adobe Experience Manager (“AEM”) offering and increases in Adobe Campaign and Adobe Analytics revenue.

Our total deferred revenue of \$1.61 billion as of March 4, 2016 increased by \$123.4 million, or 8%, from \$1.49 billion as of November 27, 2015 primarily due to new contracts and existing renewals for our Adobe Marketing Cloud services and increases in Creative Cloud individual and team subscriptions.

Cost of revenue of \$198.6 million during the three months ended March 4, 2016 increased by \$31.8 million, or 19%, compared with the year-ago period primarily due to increases in costs associated with compensation and related benefits driven by increased headcount and higher incentive compensation program achievement, and royalty costs including royalty payments related to our stock photography offering from the acquisition of Fotolia during the first quarter of fiscal 2015. Also contributing to the overall increase in cost of revenue was the increase in costs associated with training and consulting services provided to our customers.

Operating expenses of \$877.0 million during the three months ended March 4, 2016 increased by \$107.6 million, or 14%, compared with the year-ago period primarily due to increases in costs associated with compensation and related benefits driven by increased headcount and higher incentive compensation costs. Also contributing to the overall increase in operating expenses are higher corporate marketing expenses driven by increased marketing activities during the first quarter of fiscal 2016.

Net income of \$254.3 million during the three months ended March 4, 2016 increased by \$169.4 million, or 200%, compared with the year-ago period primarily due to revenue increases.

Net cash flow from operations of \$497.5 million during the three months ended March 4, 2016 increased by \$314.5 million, or 172%, compared to the three months ended February 27, 2015 primarily due to higher net income, increases in deferred revenue and decreases in accounts receivable.

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Revenue for the Three Months Ended March 4, 2016 and February 27, 2015 (dollars in millions)

	Three Months			
	2016	2015	% Change	
Subscription	\$1,070.2	\$713.4	50	%
Percentage of total revenue	77	% 64	%	
Product	201.1	290.8	(31)%
Percentage of total revenue	15	% 26	%	
Services and support	112.0	105.0	7	%
Percentage of total revenue	8	% 9	%	
Total revenue	\$1,383.3	\$1,109.2	25	%

Our subscription revenue is comprised primarily of fees we charge for our subscription and hosted service offerings including Creative Cloud and certain of our Adobe Marketing Cloud and Document Cloud services. We recognize subscription revenue ratably over the term of agreements with our customers, beginning on the commencement of the service. We expect our subscription revenue will continue to increase as a result of our investments in new SaaS and subscription models.

As described in Note 14 of our Notes to Condensed Consolidated Financial Statements, we have the following segments: Digital Media, Digital Marketing and Print and Publishing. Subscription revenue by reportable segment for the three months ended March 4, 2016 and February 27, 2015 are as follows (dollars in millions):

	Three Months			
	2016	2015	% Change	
Digital Media	\$781.9	\$483.8	62	%
Digital Marketing	280.9	224.9	25	%
Print and Publishing	7.4	4.7	57	%
Total subscription revenue	\$1,070.2	\$713.4	50	%

Our services and support revenue is comprised of consulting, training and maintenance and support, primarily related to the licensing of our enterprise, developer and platform products and the sale of our hosted Adobe Marketing Cloud services. Our support revenue also includes technical support and developer support to partners and developer organizations related to our desktop products. Our maintenance and support offerings, which entitle customers to receive desktop product upgrades and enhancements or technical support, depending on the offering, are generally recognized ratably over the term of the arrangement.

Segment Information (dollars in millions)

	Three Months			
	2016	2015	% Change	
Digital Media	\$931.7	\$702.8	33	%
Percentage of total revenue	68	% 63	%	
Digital Marketing	406.2	357.2	14	%
Percentage of total revenue	29	% 32	%	
Print and Publishing	45.4	49.2	(8)%
Percentage of total revenue	3	% 4	%	
Total revenue	\$1,383.3	\$1,109.2	25	%

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Digital Media

Revenue from Digital Media increased \$228.9 million during the three months ended March 4, 2016, as compared to the three months ended February 27, 2015 primarily driven by increases in revenue associated with our creative offerings. Document Cloud revenue increased slightly during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015.

Revenue associated with our creative offerings, which includes our Creative Cloud and perpetual creative offerings, increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 primarily due to the increase in subscription revenue associated with our Creative Cloud offerings driven by the increase in number of paid Creative Cloud individual and team subscriptions. Also contributing to the increase in revenue associated with our creative offerings were increases in revenue associated with our Creative Cloud Photography Plan subscription offering and stock photography offering from the acquisition of Fotolia in the latter part of the first quarter of fiscal 2015. The increases associated with our creative products were slightly offset by expected declines in revenue associated with our other perpetual creative offerings and distribution of third-party software downloads.

Document Cloud revenue, which includes our Acrobat product family, increased slightly during the three months ended March 4, 2016 as compared to the year ago period primarily due to increases in revenue associated with Adobe eSign and our Document Cloud subscription offering, partially offset by decreases in revenue associated with our Document Cloud perpetual license offerings.

Digital Marketing

Revenue from Digital Marketing increased \$49.0 million during the three months ended March 4, 2016, as compared to the three months ended February 27, 2015 primarily due to continued revenue growth associated with our Adobe Marketing Cloud, which increased 21% during the three months ended March 4, 2016 as compared to the year-ago period. Contributing to this increase were the continued adoption of our AEM offerings and increases in revenue associated with Adobe Analytics and Adobe Campaign.

Geographical Information (dollars in millions)

	Three Months			
	2016	2015	% Change	
Americas	\$806.5	\$644.6	25	%
Percentage of total revenue	58	% 58	%	
EMEA	385.6	307.1	26	%
Percentage of total revenue	28	% 28	%	
APAC	191.2	157.5	21	%
Percentage of total revenue	14	% 14	%	
Total revenue	\$1,383.3	\$1,109.2	25	%

Overall revenue during the three months ended March 4, 2016 increased in all geographic regions as compared to the three months ended February 27, 2015 primarily due to increases in Digital Media and Digital Marketing revenue, slightly offset by the decline in Print and Publishing revenue. Within each geographic region, the fluctuations in revenue by reportable segment were attributable to the factors noted in the segment information above. The overall increase in revenue was slightly offset by declines due to the relative strength of the U.S. Dollar against EMEA currencies during the three months ended March 4, 2016 as compared to the year-ago period.

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Foreign currency impacts to revenue for the three months ended March 4, 2016 are shown below.

(in millions)	2016 Increase/ (Decrease)
Revenue impact:	
EMEA:	
Euro	\$(28.6)
British Pound	(5.0)
Other currencies	(1.4)
Total EMEA	(35.0)
Japanese Yen	(4.3)
Other currencies	(8.8)
Total revenue impact	(48.1)
Hedging impact:	
Euro	1.2
British Pound	1.9
Japanese Yen	0.1
Total hedging impact	3.2
Total impact	\$(44.9)

During the three months ended March 4, 2016, the relative strength of the U.S. Dollar against EMEA currencies caused revenue in EMEA measured in U.S. Dollar equivalents to decrease as compared to the year-ago period. These decreases were slightly offset by hedging gains from our Euro, British Pound and Japanese Yen hedging programs during the three months ended March 4, 2016.

Cost of Revenue for the Three Months Ended March 4, 2016 and February 27, 2015 (dollars in millions)

	Three Months			
	2016	2015	% Change	
Subscription	\$107.3	\$95.5	13	%
Percentage of total revenue	8	% 9	%	
Product	20.3	19.7	3	%
Percentage of total revenue	1	% 2	%	
Services and support	71.0	51.6	38	%
Percentage of total revenue	5	% 5	%	
Total cost of revenue	\$198.6	\$166.8	19	%
Subscription				

Cost of subscription revenue consists of third-party royalties and expenses related to operating our network infrastructure, including depreciation expenses and operating lease payments associated with computer equipment, data center costs, salaries and related expenses of network operations, implementation, account management and technical support personnel, amortization of intangible assets and allocated overhead. We enter into contracts with third parties for the use of their data center facilities and our data center costs largely consist of the amounts we pay to these third parties for rack space, power and similar items.

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Cost of subscription revenue increased due to the following:

	% Change 2016-2015 QTD	
Data center costs	6	%
Compensation and related benefits associated with headcount	3	
Depreciation expense	2	
Royalty cost	3	
Amortization of purchased intangibles	(1)
Total change	13	%

Data center costs increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 primarily due to higher transaction volumes in our Adobe Marketing Cloud and Creative Cloud services. Royalty cost increased during the three months ended March 4, 2016 as compared to the year-ago period due to increased royalty payments related to our stock photography offering from the acquisition of Fotolia in the first quarter of fiscal 2015. Depreciation expense increased during the three months ended March 4, 2016 as compared to the year-ago periods primarily due to higher capital expenditures in recent periods as we continue to invest in our network and data center infrastructure to support the growth of our subscription and hosted services business.

Product

Cost of product revenue includes product packaging, third-party royalties, excess and obsolete inventory, amortization related to localization costs, purchased intangibles and acquired rights to use technology and the costs associated with the manufacturing of our products.

Cost of product revenue increased 3% during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 primarily due to an increase in royalty costs related to our stock photography perpetual offering from our acquisition of Fotolia in the first quarter of fiscal 2015, largely offset by decreases in localization costs, amortization of purchased intangibles, cost of sales and excess and obsolete inventory.

Services and Support

Cost of services and support revenue is primarily comprised of employee-related costs and associated costs incurred to provide consulting services, training and product support.

Cost of services and support revenue increased due to the following:

	% Change 2016-2015 QTD	
Compensation associated with cash and stock-based incentives	23	%
Compensation and related benefits associated with headcount	(3)
Professional and consulting fees	15	
Various individually insignificant items	3	
Total change	38	%

Professional and consulting fees increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 primarily due to increases in third-party fees related to training and consulting services provided to our customers.

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Operating Expenses for the Three Months Ended March 4, 2016 and February 27, 2015 (dollars in millions)

	Three Months			
	2016	2015	% Change	
Research and development	\$237.2	\$215.5	10	%
Percentage of total revenue	17	% 19	%	
Sales and marketing	474.9	392.7	21	%
Percentage of total revenue	34	% 35	%	
General and administrative	146.9	145.1	1	%
Percentage of total revenue	11	% 13	%	
Restructuring and other charges	(0.4) 1.8	**	
Percentage of total revenue	*	*		
Amortization of purchased intangibles	18.4	14.3	29	%
Percentage of total revenue	1	% 1	%	
Total operating expenses	\$877.0	\$769.4	14	%

(*) Percentage is less than 1%.

(**) Percentage is not meaningful.

Research and Development, Sales and Marketing, and General and Administrative Expenses

The increase in research and development, sales and marketing and general and administrative expenses during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 was primarily due to the increase in costs associated with compensation and related benefits driven by increased headcount and cash incentives due to higher costs associated with our incentive compensation program in fiscal 2016.

Research and Development

Research and development expenses consist primarily of salary and benefit expenses for software developers, contracted development efforts, related facilities costs and expenses associated with computer equipment used in software development.

Research and development expenses increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 due to the following:

	% Change 2016-2015 QTD	
Compensation and related benefits associated with headcount	4	%
Compensation associated with cash and stock-based incentives	6	
Professional and consulting fees	4	
Seminars and customer events	(4)
Total change	10	%

The decrease in seminars and customer events during the three months ended March 4, 2016 as compared to the three months ended March 4, 2015 is primarily due to a technical event for our engineers which was held during the first quarter of fiscal 2015 that did not occur during the first quarter of fiscal 2016.

We believe that investments in research and development, including the recruiting and hiring of software developers, are critical to remain competitive in the marketplace and are directly related to continued timely development of new and enhanced offerings and solutions. We will continue to focus on long-term opportunities available in our end markets and make significant investments in the development of our subscription and service offerings, applications and tools.

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Sales and Marketing

Sales and marketing expenses consist primarily of salary and benefit expenses, sales commissions, travel expenses and related facilities costs for our sales, marketing, order management and global supply chain management personnel. Sales and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows, public relations and other market development programs.

Sales and marketing expenses increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 due to the following:

	% Change 2016-2015 QTD	
Compensation associated with cash and stock-based incentives	5	%
Compensation and related benefits associated with headcount	6	
Marketing spending related to product launches and overall marketing efforts	7	
Various individually insignificant items	3	
Total change	21	%

General and Administrative

General and administrative expenses consist primarily of compensation and benefit expenses, travel expenses and related facilities costs for our finance, facilities, human resources, legal, information services and executive personnel. General and administrative expenses also include outside legal and accounting fees, provision for bad debts, expenses associated with computer equipment and software used in the administration of the business, charitable contributions and various forms of insurance.

General and administrative expenses increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 due to the following:

	% Change 2016-2015 QTD	
Compensation associated with cash and stock-based incentives	3	%
Compensation and related benefits associated with headcount	4	
Charitable contributions	(11)
Software licenses	3	
Various individually insignificant items	2	
Total change	1	%

The decrease in charitable contributions during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 is primarily due to the timing of planned contributions to the Adobe Foundation.

Amortization of Purchased Intangibles

Amortization expenses increased 29% during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 primarily due to amortization expense associated with intangible assets purchased through our acquisition of Fotolia in the first quarter of fiscal 2015.

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Non-Operating Income (Expense), Net for the Three Months Ended March 4, 2016 and February 27, 2015 (dollars in millions)

	Three Months			
	2016	2015	% Change	
Interest and other income (expense), net	\$4.2	\$3.3	27	%
Percentage of total revenue	*	*		
Interest expense	(18.5)	(14.5)	28	%
Percentage of total revenue	(1)	(1)		%
Investment gains (losses), net	(1.2)	1.4	**	
Percentage of total revenue	*	*		
Total non-operating income (expense), net	\$(15.5)	\$(9.8)	58	%

(*) Percentage is less than 1%.

(**) Percentage is not meaningful.

Interest and Other Income (Expense), Net

Interest and other income (expense), net consists primarily of interest earned on cash, cash equivalents and short-term fixed income investments. Interest and other income (expense), net also includes gains and losses on fixed income investments and foreign exchange gains and losses other than any gains recorded to revenue from hedging Euros, British Pounds and Yen currencies.

Interest Expense

Interest expense primarily represents interest associated with our senior notes and interest rate swaps. Interest on our senior notes is payable semi-annually, in arrears, on February 1 and August 1. Floating interest payments on the interest rate swaps are paid monthly. The fixed-rate interest receivable on the swaps is received semi-annually concurrent with the senior notes interest payments.

Interest expense increased during the three months ended March 4, 2016 as compared to the three months ended February 27, 2015 due to increases in total debt, partially offset by the favorable impact of the interest rate swaps. See Notes 5 and 12 of our Notes to Condensed Consolidated Financial Statements for further details regarding our senior notes and interest rate swaps.

Investment Gains (Losses), Net

Investment gains (losses), net consists principally of realized gains and losses from the sale of marketable equity investments, other-than-temporary declines in the value of marketable and non-marketable equity securities and unrealized holding gains and losses associated with our deferred compensation plan assets (classified as trading securities) and gains and losses associated with our direct and indirect investments in privately held companies.

Provision for Income Taxes for the Three Months Ended March 4, 2016 and February 27, 2015 (dollars in millions)

	Three Months			
	2016	2015	% Change	
Provision	\$38.0	\$78.4	(51.5)	%)
Percentage of total revenue	3	7		%
Effective tax rate	13	48		%

Our effective tax rate decreased by 35 percentage points for the three months ended March 4, 2016 as compared to the three months ended February 27, 2015. The decrease was primarily due to U.S. tax benefits related to the permanent extension of the U.S. Research and Development credit for 2015 and onward. The reinstatement of the credit was retroactive to January 1, 2015. A tax benefit for the credit relating to fiscal 2015 was reflected in its entirety in the first quarter of fiscal 2016. In addition, the effective tax rate during the three months ended February 27, 2015 included a one-time tax cost associated with licensing acquired company assets to Adobe's trading companies, offset by tax benefits for the temporary reinstatement of the U.S. Research and Development credit in December 2014.

We are a United States-based multinational company subject to tax in multiple U.S. and foreign tax jurisdictions. A significant portion of our foreign earnings for the current fiscal year were earned by our Irish subsidiaries. In addition to providing for U.S. income taxes on earnings from the United States, we provide for U.S. income taxes on the earnings of foreign subsidiaries unless

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the subsidiaries' earnings are considered permanently reinvested outside the United States. While we do not anticipate changing our intention regarding permanently reinvested earnings, if certain foreign earnings previously treated as permanently reinvested are repatriated, the related U.S. tax liability may be reduced by any foreign income taxes paid on these earnings. Currently, there is a significant amount of foreign earnings upon which U.S. income taxes have not been provided.

Accounting for Uncertainty in Income Taxes

The gross liability for unrecognized tax benefits at March 4, 2016 was \$262.7 million, exclusive of interest and penalties. If the total unrecognized tax benefits at March 4, 2016 were recognized in the future, \$224.9 million of unrecognized tax benefits would decrease the effective tax rate, which is net of an estimated \$37.8 million federal benefit related to deducting certain payments on future state tax returns.

As of March 4, 2016, the combined amount of accrued interest and penalties related to tax positions taken on our tax returns was \$29.6 million. This amount is included in non-current income taxes payable.

The timing of the resolution of income tax examinations is highly uncertain as are the amounts and timing of tax payments that are part of any audit settlement process. These events could cause large fluctuations in the balance sheet classification of current and non-current assets and liabilities. We believe that within the next 12 months, it is reasonably possible that either certain audits will conclude or statutes of limitations on certain income tax examination periods will expire, or both. Given the uncertainties described above, we can only determine a range of estimated potential decreases in underlying unrecognized tax benefits ranging from \$0 to approximately \$10.0 million.

LIQUIDITY AND CAPITAL RESOURCES

This data should be read in conjunction with our Condensed Consolidated Statements of Cash Flows.

(in millions)	As of	
	March 4, 2016	November 27, 2015
Cash and cash equivalents	\$830.7	\$876.6
Short-term investments	\$3,267.2	\$3,111.5
Working capital	\$2,703.6	\$2,608.3
Stockholders' equity	\$7,081.2	\$7,001.6

A summary of our cash flows is as follows:

(in millions)	Three Months Ended	
	March 4, 2016	February 27, 2015
Net cash provided by operating activities	\$497.5	\$183.0
Net cash used for investing activities	(258.8)	(698.4)
Net cash provided by (used for) financing activities	(284.4)	119.3
Effect of foreign currency exchange rates on cash and cash equivalents	(0.2)	(8.4)
Net decrease in cash and cash equivalents	\$(45.9)	\$(404.5)

Our primary source of cash is receipts from revenue. The primary uses of cash are payroll-related expenses, general operating expenses including marketing, travel and office rent, and cost of revenue. Other sources of cash are proceeds from the exercise of employee stock options and participation in the employee stock purchase plan. Other uses of cash include our stock repurchase program, which is described below, business acquisitions and purchases of property and equipment.

Cash Flows from Operating Activities

Net cash provided by operating activities of \$497.5 million for the three months ended March 4, 2016 was primarily comprised of net income plus the net effect of non-cash items. The primary working capital sources of cash were net income coupled with increases in deferred revenue, and decreases in trade receivables. The increase in deferred revenue is primarily due to increases in Digital Marketing hosted services and increased subscriptions for our Creative Cloud offerings. Trade receivables declined primarily due to improved collections during the three months ended March 4, 2016 within the same quarter as a result of the extra week in the quarter.

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The primary working capital uses of cash were increases in prepaid expenses and other current assets and decreases in accrued expenses. Prepaid expenses increased primarily due to higher prepaid employee benefit expenses largely associated with recognition of yearly fringe benefit expenses which are estimated and recorded at the beginning of the fiscal year and expensed throughout the fiscal year. Other current assets increased primarily due to the tax benefit associated with the reinstatement of the federal research and development tax credit and bonus depreciation provisions. Accrued expenses decreased primarily due to payment of fiscal 2015 bonuses, commissions, and other incentive plans in the first quarter of fiscal 2016. We also made a semi-annual interest payment associated with our senior notes during the three months ended March 4, 2016. These reductions were partially offset by additional interest accruals made during the period.

Cash Flows from Investing Activities

Net cash used for investing activities of \$258.8 million for the three months ended March 4, 2016 was primarily due to purchases of short-term investments. Other uses of cash during the three months ended March 4, 2016 represented purchases of property and equipment, and long-term investments and other assets. These cash outflows were offset in part by sales and maturities of short-term investments.

Cash Flows from Financing Activities

Net cash used for financing activities of \$284.4 million was primarily due to payments for our treasury stock repurchases and costs associated with the issuance of treasury stock, offset in part by proceeds from the issuance of treasury stock and excess tax benefits from stock-based compensation. See the section titled “Stock Repurchase Program” discussed below.

We expect to continue our investing activities, including short-term and long-term investments, venture capital, facilities expansion and purchases of computer systems for research and development, sales and marketing, product support and administrative staff. Furthermore, cash reserves may be used to repurchase stock under our stock repurchase program and to strategically acquire companies, products or technologies that are complementary to our business.

Other Liquidity and Capital Resources Considerations

Our existing cash, cash equivalents and investment balances may fluctuate during fiscal 2016 due to changes in our planned cash outlay, including changes in incremental costs such as direct and integration costs related to our acquisitions. Our intent is to permanently reinvest a significant portion of our earnings from foreign operations, and current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed to fund operations in the United States and if U.S. tax has not already been previously provided, we would provide for and pay additional U.S. taxes in connection with repatriating these funds.

Cash from operations could also be affected by various risks and uncertainties, including, but not limited, to the risks detailed in Part II, Item 1A titled “Risk Factors”. However, based on our current business plan and revenue prospects, we believe that our existing cash, cash equivalents and investment balances, our anticipated cash flows from operations and our available credit facility will be sufficient to meet our working capital and operating resource expenditure requirements for the next twelve months.

On March 2, 2012, we entered into a five-year \$1 billion senior unsecured revolving credit agreement (the “Credit Agreement”), providing for loans to us and certain of our subsidiaries. On March 1, 2013, we exercised our option under the Credit Agreement to extend the maturity date of the Credit Agreement by one year to March 2, 2018. On July 27, 2015, we entered into an amendment to further extend the maturity date of the Credit Agreement to July 27, 2020 and reallocated the facility among the syndicate of lenders that are parties to the Credit Agreement. As of March 4, 2016, there were no outstanding borrowings under this Credit Agreement and the entire \$1 billion credit line remains available for borrowing.

As of March 4, 2016, the amount outstanding under our senior notes was \$1.9 billion, consisting of \$900 million of 4.75% senior notes due February 1, 2020 and \$1 billion of 3.25% senior notes due February 1, 2025 .

Our short-term investment portfolio is primarily invested in corporate bonds and commercial paper, U.S. agency securities and U.S. Treasury securities, foreign government securities, municipal securities and asset-backed securities. We use professional investment management firms to manage a large portion of our invested cash. External investment firms managed, on average, 59% of our consolidated invested balances during fiscal 2016.

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Stock Repurchase Program

To facilitate our stock repurchase program, designed to return value to our stockholders and minimize dilution from stock issuances, we may repurchase shares in the open market or enter into structured repurchase agreements with third parties. In the first quarter of fiscal 2015, the Board of Directors approved a new stock repurchase program granting the Company authority to repurchase up to \$2 billion in common stock through the end of fiscal 2017. During the three months ended March 4, 2016 and February 27, 2015, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling \$150 million and \$200 million, respectively. The prepayment of \$150 million for the three months ended March 4, 2016 was under the current \$2 billion authority while the prepayment of \$200 million during the three months ended February 27, 2015 was under the previous \$2 billion authority. We enter into these agreements in order to take advantage of repurchasing shares at a guaranteed discount to the Volume Weighted Average Price ("VWAP") of our common stock over a specified period of time. We only enter into such transactions when the discount that we receive is higher than the foregone return on our cash prepayments to the financial institutions. There were no explicit commissions or fees on these structured repurchases. Under the terms of the agreements, there is no requirement for the financial institutions to return any portion of the prepayment to us.

The financial institutions agree to deliver shares to us at monthly intervals during the contract term. The parameters used to calculate the number of shares deliverable are: the total notional amount of the contract, the number of trading days in the contract, the number of trading days in the interval and the average VWAP of our stock during the interval less the agreed upon discount. During the three months ended March 4, 2016, we repurchased approximately 1.5 million shares at an average price of \$88.67 through structured repurchase agreements entered into during fiscal 2015 and the three months ended March 4, 2016. During the three months ended February 27, 2015, we repurchased approximately 2.4 million shares at an average price of \$72.39 through structured repurchase agreements entered into during fiscal 2014 and the three months ended February 27, 2015.

For the three months ended March 4, 2016, the prepayments were classified as treasury stock on our Condensed Consolidated Balance Sheets at the payment date, though only shares physically delivered to us by March 4, 2016 were excluded from the computation of earnings per share. As of March 4, 2016, \$54.8 million of prepayments remained under the agreement.

Subsequent to March 4, 2016, as part of our \$2 billion stock repurchase program, we entered into a structured stock repurchase agreement with a large financial institution whereupon we provided them with a prepayment of \$225 million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the \$225 million stock repurchase agreement, \$1.2 billion remains under our current authority.

Refer to Part II, Item 2 in this report for share repurchases during the quarter ended March 4, 2016.

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

We presented our contractual obligations in our Annual Report on Form 10-K for the fiscal year ended November 27, 2015. Our principal commitments as of March 4, 2016 consist of obligations under operating leases, royalty agreements and various service agreements. Except as discussed below, there have been no material changes in those obligations during the three months ended March 4, 2016. See Notes 11 and 12 of our Notes to Condensed Consolidated Financial Statements for more detailed information regarding our contractual commitments.

Senior Notes

Interest on our senior notes is payable semi-annually, in arrears on February 1 and August 1. At March 4, 2016, our maximum commitment for interest payments was \$463.5 million for the remaining duration of our senior notes.

Covenants

Our credit facility contains a financial covenant requiring us not to exceed a maximum leverage ratio. Our Almaden Tower lease includes certain financial ratios as defined in the lease agreements that are reported to the lessor quarterly. As of March 4, 2016, we were in compliance with all of our covenants. We believe these covenants will not impact our credit or cash in the coming fiscal year or restrict our ability to execute our business plan. Our senior notes do not contain any financial covenants.

Under the terms of our credit agreement and lease agreements, we are not prohibited from paying cash dividends unless payment would trigger an event of default or one currently exists. We do not anticipate paying any cash dividends in the foreseeable future.

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Royalties

We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit sold or a percentage of the underlying revenue.

Indemnifications

In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products and from time to time, we are subject to claims by our customers under these indemnification provisions. Historically, costs related to these indemnification provisions have not been significant and we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

To the extent permitted under Delaware law, we have agreements whereby we indemnify our directors and officers for certain events or occurrences while the director or officer is or was serving at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the director's or officer's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited, however, we have director and officer insurance coverage that limits our exposure and enables us to recover a portion of any future amounts paid.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We believe that there have been no material changes in our market risk exposures for the three months ended March 4, 2016, as compared with those discussed in our Annual Report on Form 10-K for the fiscal year ended November 27, 2015.

ITEM 4. CONTROLS AND PROCEDURES

Based on their evaluation as of March 4, 2016, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were effective at the reasonable assurance level to ensure that the information required to be disclosed by us in this Quarterly Report on Form 10-Q was (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting during the quarter ended March 4, 2016 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Adobe have been detected.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 11 "Commitments and Contingencies" of our Notes to Condensed Consolidated Financial Statements regarding our legal proceedings.

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ITEM 1A. RISK FACTORS

As previously discussed, our actual results could differ materially from our forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed below. These and many other factors described in this report could adversely affect our operations, performance and financial condition.

If we cannot continue to develop, market and offer new products and services or enhancements to existing products and services that meet customer requirements, our operating results could suffer.

The process of developing new high technology products and services and enhancing existing products and services is complex, costly and uncertain. If we fail to anticipate customers' changing needs and emerging technological trends, our market share and results of operations could suffer. We must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect customer demand for our products and services. If we are unable to extend our core technologies into new applications and new platforms and to anticipate or respond to technological changes, the market's acceptance of our products and services could decline and our results would suffer. Additionally, any delay in the development, production, marketing or offering of a new product or service or enhancement to an existing product or service could result in customer attrition or impede our ability to attract new customers, causing a decline in our revenue, earnings or stock price and weakening our competitive position. We maintain strategic relationships with third parties to market certain of our products and services and support certain product functionality. If we are unsuccessful in establishing or maintaining our relationships with these third parties, our ability to compete in the marketplace, to reach new customers and geographies or to grow our revenue could be impaired and our operating results could suffer.

We offer our products on a variety of personal computers, tablet and mobile devices. Recent trends have shown a technological shift from personal computers to tablet and mobile devices. If we cannot continue to adapt our products to tablet and mobile devices, our business could be harmed. To the extent that consumer purchases of these devices slow down, or to the extent that significant demand arises for our products or competitive products on other platforms before we offer our products on those platforms, our business could be harmed. Releases of new devices or operating systems may make it more difficult for our products to perform or may require significant costs in order for us to adapt our solutions to such devices or operating systems. These potential costs and delays could harm our business. Introduction of new products, services and business models by competitors or others could harm our competitive position and results of operations.

The markets for our products and services are characterized by intense competition, evolving industry standards, emerging business and distribution models, disruptive technology developments, short product and service life cycles, price sensitivity on the part of customers and frequent new product introductions (including alternatives with limited functionality available at lower costs or free of charge). Any of these factors could create downward pressure on pricing and gross margins and could adversely affect our renewal and upgrade rates, as well as our ability to attract new customers. Our future success will depend on our ability to enhance and better integrate our existing products and services, introduce new products and services on a timely and cost-effective basis, meet changing customer needs, extend our core technology into new applications, and anticipate and respond to emerging standards, business models, software delivery methods and other technological developments, such as the evolution and emergence of digital application marketplaces as a direct sales and software delivery environment. These digital application marketplaces often have exclusive distribution for certain platforms, which may make it more difficult for us to compete in these markets. If any competing products, services or operating systems that do not support our solutions achieve widespread acceptance, our operating results could suffer. In addition, consolidation has occurred among some of the competitors in the markets in which we compete. Further consolidations in these markets may subject us to increased competitive pressures and may therefore harm our results of operations.

The introduction of certain technologies may reduce the effectiveness of our products. For example, some of our products rely on third-party cookies, which are placed on individual browsers when consumers visit websites that contain advertisements. We use these cookies to help our customers more effectively advertise, to gauge the performance of their advertisements, and to detect and prevent fraudulent activity. Consumers can block or delete cookies through their browsers or "ad-blocking" software or applications. The most common Internet browsers allow consumers to modify their browser settings to prevent cookies from being accepted by their browsers, or are set to

block third-party cookies by default. Increased use of methods, software or applications that block cookies could harm our business.

For additional information regarding our competition and the risks arising out of the competitive environment in which we operate, see the section entitled “Competition” contained in Item 1 of our Annual Report on Form 10-K for the fiscal year ended November 27, 2015.

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If we fail to successfully manage transitions to new business models and markets, our results of operations could suffer.

We often release new offerings and employ new product and services delivery methods in connection with our diversification into new business models and markets. It is uncertain whether these strategies will prove successful or whether we will be able to develop the necessary infrastructure and business models more quickly than our competitors. Market acceptance of new product and service offerings will be dependent in part on our ability to (1) include functionality and usability that satisfy customer requirements and (2) optimally price our products and services in light of marketplace conditions, our costs and customer demand. New product and service offerings may increase our risk of liability related to the provision of services and cause us to incur significant technical, legal or other costs. For example, with our cloud-based services and subscription-based licensing models, such as Creative Cloud, we have entered markets that may not be fully accustomed to cloud-based subscription offerings. Market acceptance of such services is affected by a variety of factors, including information security, reliability, performance, customer preference, social and community engagement, local government regulations regarding online services and user-generated content, the sufficiency of technological infrastructure to support our products and services in certain geographies, customer concerns with entrusting a third party to store and manage customer data, consumer concerns regarding data privacy and the enactment of laws or regulations that restrict our ability to provide such services to customers in the United States or internationally. If we are unable to respond to these factors, our business could be harmed.

From time to time we open-source certain of our technology initiatives, provide broader open access to our technology, license certain of our technology on a royalty-free basis, or release selected technology for industry standardization. Additionally, customer requirements for open standards or open-source products could impact adoption or use of some of our products or services. To the extent we incorrectly predict customer requirements for such products or services, or if there is a delay in market acceptance of such products or services, our business could be harmed.

We also devote significant resources to the development of technologies and service offerings in markets where our operating history is less extensive, such as the marketplace for stock imagery. These new offerings and markets may require a considerable investment of technical, financial, compliance and sales resources, and a scalable organization. Some of our competitors may have advantages over us due to their larger presence, larger developer network, deeper market experience and larger sales, consulting and marketing resources. In addition, the metrics we use to gauge the status of our business model transition may evolve over the course of the transition as significant trends emerge. If we are unable to successfully establish new offerings in light of the competitive environment, our results of operations could suffer.

Subscription offerings and ETLAs could create risks related to the timing of revenue recognition.

Our subscription model creates certain risks related to the timing of revenue recognition and potential reductions in cash flows. A portion of the subscription-based revenue we report each quarter results from the recognition of deferred revenue relating to subscription agreements entered into during previous quarters. A decline in new or renewed subscriptions in any period may not be immediately reflected in our reported financial results for that period, but may result in a decline in our revenue in future quarters. If we were to experience significant downturns in subscription sales and renewal rates, our reported financial results might not reflect such downturns until future periods. Our subscription model could also make it difficult for us to rapidly increase our revenue from subscription-based or hosted services through additional sales in any period, as revenue from new customers will be recognized over the applicable subscription term. Further, any increases in sales under our subscription sales model could result in decreased revenue over the short term if they are offset by a decline in sales from perpetual license customers. Additionally, in connection with our sales efforts to enterprise customers and our use of ETLAs, a number of factors could affect our revenue, including longer than expected sales and implementation cycles, potential deferral of revenue due to multiple-element revenue arrangements and alternative licensing arrangements. If any of our assumptions about revenue from our new businesses or our addition of a subscription-based model prove incorrect, our actual results may vary materially from those anticipated, estimated or projected.

Uncertainty about current and future economic conditions and other adverse changes in general political conditions in any of the major countries in which we do business could adversely affect our operating results.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in economic and political conditions, both domestically and globally. Uncertainty about the effects of current and future economic and political conditions on us, our customers, suppliers and partners makes it difficult for us to forecast operating results and to make decisions about future investments. If economic growth in countries where we do business slows, customers may delay or reduce technology purchases, advertising spending or marketing spending. This could result in reductions in sales of our products and services, more extended sales cycles, slower adoption of new technologies and increased price competition. Our customers include government entities, including the U.S. federal government, and if spending cuts impede the government's ability to purchase our products and services, our revenue could decline. Deterioration in economic conditions in any of the countries in which we do business

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could also cause slower or impaired collections on accounts receivable, which may adversely impact our liquidity and financial condition.

A financial institution credit crisis could impair credit availability and the financial stability of our customers, including our distribution partners and channels. A disruption in the financial markets may also have an effect on our derivative counterparties and could also impair our banking partners, on which we rely for operating cash management. Any of these events would likely harm our business, results of operations and financial condition. Political instability in or around any of the major countries in which we do business would also likely harm our business, results of operations and financial condition.

The increased emphasis on a cloud strategy may give rise to risks that could harm our business.

Over the past several years, our business has shifted away from pre-packaged software to focus on a subscription model that prices and delivers our products and services in a way that differs from our historical pricing and delivery methods. These changes reflect a significant shift from perpetual license sales and distribution of our software in favor of providing our customers the right to access certain of our software in a hosted environment or use downloaded software for a specified subscription period. This cloud strategy requires continued investment in product development and cloud operations, and may give rise to a number of risks, including the following:

- if customers desire only perpetual licenses or to purchase or renew subscriptions for specific products rather than acquire the entire Creative Cloud offering, our subscription sales may lag behind our expectations;
- our cloud strategy may raise concerns among our customer base, including concerns regarding changes to pricing over time, service availability, information security of a cloud solution and access to files while offline or once a subscription has expired;

- customers may turn to competitive or open-source offerings;

- our sales cycles may be delayed if we need to educate customers about the benefits of our cloud solutions, including technical capabilities, security, privacy and return on investment;

- we may be unsuccessful in maintaining our target pricing, new seat adoption and projected renewal rates; or we may have to rely heavily on promotional rates to achieve target seat adoption, which could reduce average revenue per user; and

- we may incur costs at a higher than forecasted rate as we expand our cloud operations.

We may be unable to predict subscription renewal rates and the impact these rates may have on our future revenue and operating results.

The hosted business model we utilize in our Adobe Marketing Cloud offerings typically involves selling services on a subscription basis pursuant to service agreements that are generally one to three years in length. Our individual Creative Cloud and Document Cloud subscription agreements are generally month-to-month or one year in length, ETLAs for our Digital Media products and services are generally three years in length, and subscription agreements for other products and services may provide for shorter or longer terms. Our customers have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period, and some customers elect not to renew. We cannot provide assurance that our subscriptions will be renewed at the same or higher level of service, for the same number of seats or licenses or for the same duration of time, if at all. Moreover, under certain circumstances, some of our customers have the right to cancel their service agreements prior to the expiration of the terms of their agreements. We cannot provide assurance that we will be able to accurately predict future customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including their level of satisfaction with our services, our ability to continue to regularly add features and functionality, the reliability (including uptime) of our subscription services, the prices of our services, the actual or perceived information security of our systems and services, the prices of services offered by our competitors, mergers and acquisitions affecting our customer base, reductions in our customers' spending levels, or declines in customer activity as a result of economic downturns or uncertainty in financial markets. If our customers do not renew their subscriptions for our services or if they renew on terms less favorable to us, our revenue may decline.

Our future growth is also affected by our ability to sell additional features and services to our current customers, which depends on a number of factors, including customers' satisfaction with our products and services, the level of innovation reflected in those additional features, the prices of our offerings and general economic conditions. If our efforts to cross-sell and upsell to our customers are unsuccessful, the rate at which our business grows may decline.

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Security vulnerabilities in our products and systems could lead to reduced revenue or to liability claims. Maintaining the security of our products, computers and networks is a critical issue for us and our customers. Security researchers, criminal hackers and other third parties regularly develop new techniques to penetrate computer and network security measures and, as we have previously disclosed, certain parties have in the past managed to breach certain of our data security systems and misused certain of our systems and software in order to access our end users' authentication and payment information. In addition, cyber-attackers also develop and deploy viruses, worms and other malicious software programs, some of which may be specifically designed to attack our products, systems, computers or networks. Sophisticated hardware and operating system applications that we develop or procure from third parties may contain defects in design or manufacture, including bugs and other problems that could unexpectedly compromise the security of the system, or impair a customer's ability to operate or use our products. The costs to prevent, eliminate or alleviate cyber- or other security problems, bugs, viruses, worms, malicious software programs and security vulnerabilities are significant, and our efforts to address these problems may not be successful and could result in interruptions, delays, cessation of service and loss of existing or potential customers. It is impossible to predict the extent, frequency or impact of these problems on us.

Outside parties have in the past and may in the future attempt to fraudulently induce our employees or users of our products or services to disclose sensitive information via illegal electronic spamming, phishing or other tactics. Unauthorized parties may also attempt to gain physical access to our facilities in order to infiltrate our information systems. These actual and potential breaches of our security measures and the accidental loss, inadvertent disclosure or unauthorized dissemination of proprietary information or sensitive, personal or confidential data about us, our employees, our customers or their end users, including the potential loss or disclosure of such information or data as a result of hacking, fraud, trickery or other forms of deception, could expose us, our employees, our customers or the individuals affected to a risk of loss or misuse of this information. This may result in litigation and potential liability or fines, governmental inquiry or oversight or a loss of customer confidence, any of which could harm our business or damage our brand and reputation, possibly impeding our present and future success in retaining and attracting new customers and thereby requiring time and resources to repair our brand.

These problems affect our products and services in particular because cyber-attackers tend to focus their efforts on the most popular offerings (such as those with a large user base), and we expect them to continue to do so. Critical vulnerabilities may be identified in certain of our applications. These vulnerabilities could cause such applications to crash and could allow an attacker to take control of the affected system, which could result in liability to us or limit our ability to conduct our business and deliver our products and services to customers. We devote significant resources to address security vulnerabilities through engineering more secure products, enhancing security and reliability features in our products and systems, code hardening, conducting rigorous penetration tests, deploying updates to address security vulnerabilities and improving our incident response time, but these security vulnerabilities cannot be totally eliminated. The cost of these steps could reduce our operating margins, and we may be unable to implement these measures quickly enough to prevent cyber-attackers from gaining unauthorized access into our systems and products. Despite our preventative efforts, actual or perceived security vulnerabilities in our products and systems may harm our reputation or lead to claims against us (and have in the past led to such claims), and could lead some customers to seek to return products, to stop using certain services, to reduce or delay future purchases of products or services, or to use competing products or services. If we do not make the appropriate level of investment in our technology systems or if our systems become out-of-date or obsolete and we are not able to deliver the quality of data security customers require, our business could be adversely affected. Customers may also adopt security measures designed to protect their existing computer systems from attack, which could delay adoption of new technologies. Further, if we or our customers are subject to a future attack, or our technology is utilized in a third-party attack, it may be necessary for us to take additional extraordinary measures and make additional expenditures to take appropriate responsive and preventative steps. Any of these events could adversely affect our revenue or margins. Moreover, delayed sales, lower margins or lost customers resulting from the disruptions of cyber-attacks or preventative measures could adversely affect our financial results, stock price and reputation. The success of certain of our product and service offerings depends on our ability to continue to attract and retain customers of and contributors to our online marketplaces for creative content.

The success of certain of our product and service offerings, such as Adobe Stock, depends on our ability to continue to attract new customers and contributors to these online marketplaces for creative content, as well as our ability to continue to retain existing customers and contributors. To maintain and grow these businesses, we must regularly add new customers and retain existing customers. An increase in paying customers has generally resulted in more content from contributors, which increases the size of our collection and in turn attracts new paying customers. To attract new customers and contributors and retain existing ones, we rely on the functionality and features of our online marketplaces, the size and content of our collection and the effectiveness of our marketing efforts. New technologies may render the features of our online marketplaces obsolete, our collection may fail to grow as anticipated and our marketing efforts may be unsuccessful, any of which may adversely affect our results of operations.

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Some of our lines of business rely on us or our third-party service providers to host and deliver services and data, and any interruptions or delays in these hosted services, security or privacy breaches, or failures in data collection could expose us to liability and harm our business and reputation.

Some of our lines of business and services, including our online store at adobe.com, Creative Cloud, Document Cloud, other hosted Digital Media offerings and our Adobe Marketing Cloud solutions, rely on hardware and services hosted and controlled directly by us or by our third-party service providers. We do not have redundancy for all of our systems, many of our critical applications reside in only one of our data centers, and our disaster recovery planning may not account for all eventualities. If our business relationship with a third-party provider of hosting or content delivery services is negatively affected, or if one of our content delivery suppliers were to terminate its agreement with us, we might not be able to deliver the corresponding hosted offerings to our customers, which could subject us to reputational harm and cause us to lose customers and future business, thereby reducing our revenue.

We hold large amounts of customer data, some of which is hosted in third-party facilities. A security incident at those facilities or ours may compromise the confidentiality, integrity or availability of customer data. Unauthorized access to customer data stored on our computers or networks may be obtained through break-ins, breaches of our secure network by an unauthorized party, employee theft or misuse, or other misconduct. It is also possible that unauthorized access to customer data may be obtained through inadequate use of security controls by customers. Accounts created with weak passwords could allow cyber-attackers to gain access to customer data. Additionally, failure by customers to remove accounts of their own employees, or the granting of accounts by the customer in an uncontrolled manner, may allow for access by former or unauthorized customer representatives. If there were an inadvertent disclosure of personal information, or if a third party were to gain unauthorized access to the personal information we possess on behalf of our customers, our operations could be disrupted, our reputation could be damaged and we could be subject to claims or other liabilities. In addition, such perceived or actual unauthorized disclosure of the information we collect or breach of our security could damage our reputation, result in the loss of customers and harm our business. Because of the large amount of data that we collect and manage on behalf of our customers, it is possible that hardware or software failures or errors in our systems (or those of our third-party service providers) could result in data loss or corruption or cause the information that we collect to be incomplete or contain inaccuracies that our customers regard as significant. Furthermore, our ability to collect and report data may be delayed or interrupted by a number of factors, including access to the Internet, the failure of our network or software systems, security breaches or significant variability in visitor traffic on customer websites. In addition, computer viruses or other malware may harm our systems, causing us to lose data, and the transmission of computer viruses or other malware could expose us to litigation. We may also find, on occasion, that we cannot deliver data and reports to our customers in near real time because of a number of factors, including significant spikes in customer activity on their websites or failures of our network or software. If we supply inaccurate information or experience interruptions in our ability to capture, store and supply information in near real time or at all, our reputation could be harmed and we could lose customers, or we could be found liable for damages or incur other losses.

We may not realize the anticipated benefits of past or future acquisitions, and integration of these acquisitions may disrupt our business and management.

We may not realize the anticipated benefits of an acquisition of a company, division, product or technology, each of which involves numerous risks. These risks include:

- difficulty in integrating the operations and personnel of the acquired company;
- difficulty in effectively integrating the acquired technologies, products or services with our current technologies, products or services;
- difficulty in maintaining controls, procedures and policies during the transition and integration;
- entry into markets in which we have minimal prior experience and where competitors in such markets have stronger market positions;
- disruption of our ongoing business and distraction of our management and other employees from other opportunities and challenges;
- inability to retain personnel of the acquired business;
- inability to retain key customers, distributors, vendors and other business partners of the acquired business;

inability to achieve the financial and strategic goals for the acquired and combined businesses;

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- inability to take advantage of anticipated tax benefits as a result of unforeseen difficulties in our integration activities; incurring acquisition-related costs or amortization costs for acquired intangible assets that could impact our operating results;
- potential elevated delinquency or bad debt write-offs related to receivables of the acquired business we assume;
 - potential additional exposure to fluctuations in currency exchange rates;
- potential additional costs of bringing acquired companies into compliance with laws and regulations applicable to us as a multinational corporation;
- potential impairment of our relationships with employees, customers, partners, distributors or third-party providers of our technologies, products or services;
- potential failure of our due diligence processes to identify significant problems, liabilities or other challenges of an acquired company or technology, including, but not limited to, issues with the acquired company's intellectual property, product quality or product architecture, data back-up and security (including security from cyber-attacks), privacy practices, revenue recognition or other accounting practices, employee, customer or partner issues or legal and financial contingencies;
- exposure to litigation or other claims in connection with, or inheritance of claims or litigation risk as a result of, an acquisition, including, but not limited to, claims from terminated employees, customers, former stockholders or other third parties;
- incurring significant exit charges if products or services acquired in business combinations are unsuccessful;
- potential inability to conclude that our internal controls over financial reporting are effective;
- potential inability to obtain, or obtain in a timely manner, approvals from governmental authorities, which could delay or prevent such acquisitions;
- the failure of strategic investments to perform as expected or to meet financial projections
- potential delay in customer and distributor purchasing decisions due to uncertainty about the direction of our product and service offerings; and
- potential incompatibility of business cultures.

Mergers and acquisitions of high technology companies are inherently risky. If we do not complete an announced acquisition transaction or integrate an acquired business successfully and in a timely manner, we may not realize the benefits of the acquisition to the extent anticipated, and in certain circumstances an acquisition could harm our financial position.

We may incur substantial costs enforcing or acquiring intellectual property rights and defending against third-party claims as a result of litigation or other proceedings.

In connection with the enforcement of our intellectual property rights, the acquisition of third-party intellectual property rights, or disputes relating to the validity or alleged infringement of third-party intellectual property rights, including patent rights, we have been, are currently and may in the future be subject to claims, negotiations and complex, protracted litigation. Intellectual property disputes and litigation are typically costly and can be disruptive to our business operations by diverting the attention and energies of management and key technical personnel. Although we have successfully defended or resolved many past lawsuits and other disputes, we may not prevail in every case in the future. Third-party intellectual property disputes, including those initiated by patent assertion entities, could subject us to significant liabilities, require us to enter into royalty and licensing arrangements on unfavorable terms, prevent us from licensing certain of our products or offering certain of our services, subject us to injunctions restricting our sale of products or services, cause severe disruptions to our operations or the markets in which we compete, or require us to satisfy indemnification commitments with our customers, including contractual provisions under various license arrangements and service agreements. In addition, we may incur significant costs in acquiring the necessary third-party intellectual property rights for use in our products, in some cases to fulfill contractual obligations with our customers. Any of these occurrences could significantly harm our business.

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Our intellectual property portfolio is a valuable asset and we may not be able to protect our intellectual property rights, including our source code, from infringement or unauthorized copying, use or disclosure.

Our intellectual property portfolio is a valuable asset. Infringement or misappropriation of assets in this portfolio can result in lost revenues and thereby ultimately reduce their value. Preventing unauthorized use or infringement of our intellectual property rights is inherently difficult. We actively combat software piracy as we enforce our intellectual property rights, but we nonetheless lose significant revenue due to illegal use of our software. If piracy activities continue at historical levels or increase, they may further harm our business.

Additionally, we take significant measures to protect the secrecy of our confidential information and trade secrets, including our source code. Despite these measures, as we have previously disclosed, hackers have managed to access certain of our source code and may obtain access in the future. If unauthorized disclosure of our source code occurs through security breach, cyber-attack or otherwise, we could potentially lose future trade secret protection for that source code. The loss of future trade secret protection could make it easier for third parties to compete with our products by copying functionality, which could cause us to lose customers and could adversely affect our revenue and operating margins. We also seek to protect our confidential information and trade secrets through the use of non-disclosure agreements with our customers, contractors, vendors and partners. However, there is a risk that our confidential information and trade secrets may be disclosed or published without our authorization, and in these situations, enforcing our rights may be difficult or costly.

Increasing regulatory focus on privacy issues and expanding laws and regulations could impact our new business models and expose us to increased liability.

Our industry is highly regulated, including for privacy and data security. We are also expanding our business in countries that have more stringent data protection laws than those in the United States, and such laws may be inconsistent across jurisdictions and are subject to evolving and differing interpretations. Governments, privacy advocates and class action attorneys are increasingly scrutinizing how companies collect, process, use, store, share and transmit personal data. New laws and industry self-regulatory codes have been enacted and more are being considered that may affect our ability to reach current and prospective customers, to understand how our products and services are being used, to respond to customer requests allowed under the laws, and to implement our new business models effectively. Any perception of our practices, products or services as an invasion of privacy, whether or not consistent with current regulations and industry practices, may subject us to public criticism, class action lawsuits, reputational harm or claims by regulators, industry groups or other third parties, all of which could disrupt our business and expose us to increased liability. Additionally, both laws regulating privacy, as well as third-party products purporting to address privacy concerns, could affect the functionality of and demand for our products and services, thereby harming our revenue.

On behalf of certain customers, we collect and store anonymous and personal information derived from the activities of end users with various channels, including traditional websites, mobile websites and applications, email interactions, direct mail, point of sale, text messaging and call centers. Federal, state and foreign governments and agencies have adopted or are considering adopting laws regarding the collection, use and disclosure of this information. Our compliance with privacy laws and regulations and our reputation among consumers depend in part on our customers' adherence to privacy laws and regulations and their use of our services in ways consistent with such consumers' expectations. We also rely on contractual representations made to us by customers that their own use of our services and the information they provide to us via our services do not violate any applicable privacy laws, rules and regulations or their own privacy policies. We contractually obligate customers to represent to us that they provide their consumers the opportunity to "opt out" of the information collection associated with our services, as applicable. We do not formally audit such customers to confirm compliance with these representations. If these representations are false or if our customers do not otherwise comply with applicable privacy laws, we could face adverse publicity and possible legal or other regulatory action. In addition, some countries are considering enacting laws that would expand the scope of privacy-related obligations required of service providers, such as Adobe, that would require additional compliance expense and increased liability.

In the past we have relied on the U.S.-European Union and the U.S.-Swiss Safe Harbor frameworks, as agreed to by the U.S. Department of Commerce and the European Union ("EU") and Switzerland as a means to legally transfer

European personal information from Europe to the United States. However, on October 6, 2015, the European Court of Justice invalidated the U.S.-EU Safe Harbor framework and the Swiss data protection authorities later invalidated the U.S.-Swiss Safe Harbor framework. As a result, we have been working to establish alternate legitimate means of transferring personal data from the European Economic Area and Switzerland to the United States; however, we continue to face uncertainty as to the legitimacy of these alternate means. We are closely monitoring developments regarding requirements for transferring personal data from the EU. Once finalized, these requirements may result in an increase in the obligations required of us to provide our services in Europe and in potential sanctions and fines for non-compliance. These developments could harm our business, financial condition and results of operations.

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We may incur losses associated with currency fluctuations and may not be able to effectively hedge our exposure.

Because our products are distributed and used globally, our operating results are subject to fluctuations in foreign currency exchange rates. We attempt to mitigate a portion of these risks through foreign currency hedging, based on our judgment of the appropriate trade-offs among risk, opportunity and expense. We have established a program to partially hedge our exposure to foreign currency exchange rate fluctuations for various currencies. We regularly review our hedging program and make adjustments as necessary based on the factors discussed above. Our hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movement in foreign currency exchange rates, which could adversely affect our financial condition or results of operations.

If we fail to process transactions effectively, our revenue and earnings may be harmed.

We process a significant volume of transactions on a daily basis in our Digital Marketing and Digital Media businesses. Due to the size and volume of transactions that we handle, effective processing systems and controls are essential, but even the most sophisticated systems and processes may not be effective in preventing all errors. The systems supporting our business are comprised of multiple technology platforms that may be difficult to scale. If we are unable to effectively manage these systems and processes, we may be unable to process customer data in an accurate, reliable and timely manner, which may harm our customer relationships or results of operations.

Failure to manage our sales and distribution channels and third-party customer service and technical support providers effectively could result in a loss of revenue and harm to our business.

We contract with a number of software distributors, none of which is individually responsible for a material amount of our total net revenue for any recent period. Nonetheless, if any single agreement with one of our distributors were terminated, any prolonged delay in securing a replacement distributor could have a negative impact on our results of operations.

Successfully managing our indirect distribution channel efforts to reach various customer segments for our products and services is a complex process across the broad range of geographies where we do business or plan to do business. Our distributors and other channel partners are independent businesses that we do not control. Notwithstanding the independence of our channel partners, we face potential legal risk and reputational harm from the activities of these third parties including, but not limited to, export control violations, workplace conditions, corruption and anti-competitive behavior. We cannot be certain that our distribution channel will continue to market or sell our products and services effectively. If our distribution channel is not successful, we may lose sales opportunities, customers and revenue.

Our distributors also sell our competitors' products and services, and if they favor our competitors' products or services for any reason, they may fail to market our products or services effectively or to devote resources necessary to provide effective sales, which would cause our results to suffer. We also distribute some products and services through our OEM channel, and if our OEMs decide not to bundle our applications on their devices, our results could suffer.

In addition, the financial health of our distributors and our continuing relationships with them are important to our success. Some of these distributors may be adversely impacted by changes to our business model or unable to withstand adverse changes in economic conditions, which could result in insolvency and/or the inability of such distributors to obtain credit to finance purchases of our products and services. In addition, weakness in the end-user market could negatively affect the cash flows of our distributors who could, in turn, delay paying their obligations to us, which would increase our credit risk exposure. Our business could be harmed if the financial condition of some of these distributors substantially weakened and we were unable to timely secure replacement distributors.

We also sell certain of our products and services through our direct sales force. Risks associated with this sales channel include more extended sales and collection cycles associated with direct sales efforts, challenges related to hiring, retaining and motivating our direct sales force, and substantial amounts of training for sales representatives, including regular updates to cover new and upgraded systems, products and services. Moreover, recent hires may not become as productive as we would like, as in most cases it takes a significant period of time before they achieve full productivity. Our business could be seriously harmed if our expansion efforts do not generate a corresponding significant increase in revenue and we are unable to achieve the efficiencies we anticipate. In addition, the loss of key

sales employees could impact our customer relationships and future ability to sell to certain accounts covered by such employees.

We also provide products and services, directly and indirectly, to a variety of government entities, both domestically and internationally. Risks associated with licensing and selling products and services to government entities include more extended sales and collection cycles, varying governmental budgeting processes and adherence to complex procurement regulations and other government-specific contractual requirements. Ineffectively managing these risks could result in various civil and criminal

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penalties and administrative sanctions, including termination of contracts, payment of fines, and suspension or debarment from future government business, as well as harm to our reputation.

We outsource a substantial portion of our customer service and technical support activities to third-party service providers. We rely heavily on these third-party customer service and technical support representatives working on our behalf, and we expect to continue to rely heavily on third parties in the future. This strategy provides us with lower operating costs and greater flexibility, but also presents risks to our business due to the fact that we may not be able to influence the quality of support as directly as we would be able to do if our own employees performed these activities. Our customers may react negatively to providing information to, and receiving support from, third-party organizations, especially if these third-party organizations are based overseas. If we encounter problems with our third-party customer service and technical support providers, our reputation may be harmed and we could lose customers and associated revenue.

Certain of our enterprise offerings have extended and complex sales cycles, which can make our sales cycles unpredictable.

Sales cycles for some of our enterprise offerings, including our Adobe Marketing Cloud solutions and ETLAs in our Digital Media business, are multi-phased and complex. The complexity in these sales cycles is due to a number of factors, including:

- the need for our sales representatives to educate customers about the use and benefit of our large-scale deployments of our products and services, including technical capabilities, security features, potential cost savings and return on investment;
- the desire of large and medium size organizations to undertake significant evaluation processes to determine their technology requirements prior to making information technology expenditures;
- the need for our representatives to spend a significant amount of time assisting potential customers in their testing and evaluation of our products and services;
- the negotiation of large, complex, enterprise-wide contracts, as often required by our and our customers' business and legal representatives;
- the need for our customers to obtain requisition approvals from various decision makers within their organizations; and
- customer budget constraints, economic conditions and unplanned administrative delays.

We spend substantial time and expense on our sales efforts without any assurance that potential customers will ultimately purchase our solutions. As we target our sales efforts at larger enterprise customers, these trends are expected to continue and could have a greater impact on our results of operations. Additionally, our enterprise sales pattern has historically been uneven, where a higher percentage of a quarter's total sales occur during the final weeks of each quarter, which is common in our industry. Our extended sales cycle for these products and services makes it difficult to predict when a given sales cycle will close.

Catastrophic events may disrupt our business.

We are a highly automated business and rely on our network infrastructure and enterprise applications, internal technology systems and our website for our development, marketing, operational, support, hosted services and sales activities. In addition, some of our businesses rely on third-party hosted services, and we do not control the operation of third-party data center facilities serving our customers from around the world, which increases our vulnerability. A disruption, infiltration or failure of these systems or third-party hosted services in the event of a major earthquake, fire, flood, tsunami or other weather event, power loss, telecommunications failure, software or hardware malfunctions, cyber-attack, war, terrorist attack or other catastrophic event could cause system interruptions, reputational harm, loss of intellectual property, delays in our product development, lengthy interruptions in our services, breaches of data security and loss of critical data. Any of these events could prevent us from fulfilling our customers' orders or could negatively impact a country or region in which we sell our products, which could in turn decrease that country's or region's demand for our products. Our corporate headquarters, a significant portion of our research and development activities, certain of our data centers and certain other critical business operations are located in the San Francisco Bay Area, and additional facilities where we conduct significant operations are located in

the Salt Lake Valley Area, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our data centers or our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our future operating results could be adversely affected.

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Climate change may have a long-term impact on our business.

Access to clean water and reliable energy in the communities where we conduct our business, whether for our offices or for our vendors, is a priority. Our major sites in California and India are vulnerable to prolonged droughts due to climate change. While we seek to partner with organizations that mitigate their business risks associated with climate change, we recognize that there are inherent risks wherever business is conducted. In the event of a natural disaster that disrupts business due to limited access to these resources, Adobe has the potential to experience losses to our business, time required to recover, and added costs to resume operations.

Additionally, climate change may pose regulatory and environmental challenges that affect where we locate our offices, who we partner with, and how we deliver products and services to our customers.

Net revenue, margin or earnings shortfalls or the volatility of the market generally may cause the market price of our stock to decline.

The market price for our common stock has in the past experienced significant fluctuations and may do so in the future. A number of factors may affect the market price for our common stock, including:

- shortfalls in our revenue, margins, earnings, the number of paid Creative Cloud and Document Cloud subscribers, Annualized Recurring Revenue (“ARR”), bookings within our Adobe Marketing Cloud business or other key performance metrics;

- changes in estimates or recommendations by securities analysts;

- whether our results meet analysts’ expectations;

- compression or expansion of multiples used by investors and analysts to value high technology SaaS companies;

- the announcement of new products and services, product enhancements or service introductions by us or our competitors;

- the loss of large customers or our inability to increase sales to existing customers, retain customers or attract new customers;

- variations in our or our competitors’ results of operations, changes in the competitive landscape generally and developments in our industry; and

- unusual events such as significant acquisitions, divestitures, litigation, general socio-economic, regulatory, political or market conditions and other factors, including factors unrelated to our operating performance.

We are subject to risks associated with compliance with laws and regulations globally which may harm our business.

We are a global company subject to varied and complex laws, regulations and customs, both domestically and internationally. These laws and regulations relate to a number of aspects of our business, including trade protection, import and export control, data and transaction processing security, payment card industry data security standards, records management, user-generated content hosted on websites we operate, privacy practices, data residency, corporate governance, employee and third-party complaints, gift policies, conflicts of interest, employment and labor relations laws, securities regulations and other regulatory requirements affecting trade and investment. The application of these laws and regulations to our business is often unclear and may at times conflict. Compliance with these laws and regulations may involve significant costs or require changes in our business practices that result in reduced revenue and profitability. Non-compliance could also result in fines, damages, criminal sanctions against us, our officers or our employees, prohibitions on the conduct of our business, and damage to our reputation. We incur additional legal compliance costs associated with our global operations and could become subject to legal penalties if we fail to comply with local laws and regulations in U.S. jurisdictions or in foreign countries, which laws and regulations may be substantially different from those in the United States. In many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by U.S. regulations applicable to us, including the Foreign Corrupt Practices Act. We cannot provide assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, including those based in or from countries where practices that violate such U.S. laws may be customary, will not take actions in violation of our internal policies or U.S. laws and regulations. Any such violation could have an adverse effect on our business.

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We face various risks associated with our operating as a multinational corporation.

As a global business that generates approximately 42% of our total revenue from sales to customers outside of the Americas, we are subject to a number of risks, including:

- foreign currency fluctuations;
- changes in government preferences for software procurement;
- international and regional economic, political and labor conditions, including any instability or security concerns abroad;
- tax laws (including U.S. taxes on foreign subsidiaries);
- increased financial accounting and reporting burdens and complexities;
- unexpected changes in, or impositions of, legislative or regulatory requirements;
- changes in laws governing the free flow of data across international borders;
- failure of laws to protect our intellectual property rights adequately;
- inadequate local infrastructure and difficulties in managing and staffing international operations;
- delays resulting from difficulty in obtaining export licenses for certain technology, tariffs, quotas and other trade barriers;
- the imposition of governmental economic sanctions on countries in which we do business or where we plan to expand our business;
- costs and delays associated with developing products in multiple languages;
- operating in locations with a higher incidence of corruption and fraudulent business practices; and
- other factors beyond our control, including terrorism, war, natural disasters and pandemics.

If sales to any of our customers outside of the Americas are delayed or canceled because of any of the above factors, our revenue may decline.

In addition, approximately 53% of our employees are located outside the United States. Accordingly, we are exposed to changes in laws governing our employee relationships in various U.S. and foreign jurisdictions, including laws and regulations regarding wage and hour requirements, fair labor standards, employee data privacy, unemployment tax rates, workers' compensation rates, citizenship requirements and payroll and other taxes, which likely would have a direct impact on our operating costs. We may continue to expand our international operations and international sales and marketing activities. Expansion in international markets has required, and will continue to require, significant management attention and resources. We may be unable to scale our infrastructure effectively or as quickly as our competitors in these markets, and our revenue may not increase to offset these expected increases in costs and operating expenses, which would cause our results to suffer.

We have issued \$1.9 billion of notes in debt offerings and may incur other debt in the future, which may adversely affect our financial condition and future financial results.

We have \$1.9 billion in senior unsecured notes outstanding. We also have a \$1.0 billion senior unsecured revolving credit agreement, which is currently undrawn. This debt may adversely affect our financial condition and future financial results by, among other things:

- requiring the dedication of a portion of our expected cash flow from operations to service our indebtedness, thereby reducing the amount of expected cash flow available for other purposes, including capital expenditures and acquisitions; and
- limiting our flexibility in planning for, or reacting to, changes in our business and our industry.

Our senior unsecured notes and senior unsecured revolving credit agreement impose restrictions on us and require us to maintain compliance with specified covenants. Our ability to comply with these covenants may be affected by events beyond our control. If we breach any of the covenants and do not obtain a waiver from the lenders or noteholders, then, subject to applicable cure periods, any outstanding indebtedness may be declared immediately due and payable.

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In addition, changes by any rating agency to our credit rating may negatively impact the value and liquidity of both our debt and equity securities, as well as the potential costs associated with a refinancing of our debt. Under certain circumstances, if our credit ratings are downgraded or other negative action is taken, the interest rate payable by us under our revolving credit facility could increase. Downgrades in our credit ratings could also restrict our ability to obtain additional financing in the future and could affect the terms of any such financing.

Changes in accounting principles, or interpretations thereof, could have a significant impact on our financial position and results of operations.

We prepare our Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America ("GAAP"). These principles are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting principles. A change in these principles can have a significant effect on our reported results and may even retroactively affect previously reported transactions. Additionally, the adoption of new or revised accounting principles may require that we make significant changes to our systems, processes and controls.

For example, the Financial Accounting Standards Board ("FASB") is currently working together with the International Accounting Standards Board ("IASB") on several projects to further align accounting principles and facilitate more comparable financial reporting between companies who are required to follow GAAP under SEC regulations and those who are required to follow International Financial Reporting Standards outside of the United States. These efforts by the FASB and IASB may result in different accounting principles under GAAP that may result in materially different financial results for us in areas including, but not limited to, principles for recognizing revenue and lease accounting. Additionally, significant changes to GAAP resulting from the FASB's and IASB's efforts may require that we change how we process, analyze and report financial information and that we change financial reporting controls. It is not clear if or when these potential changes in accounting principles may become effective, whether we have the proper systems and controls in place to accommodate such changes and the impact that any such changes may have on our financial position and results of operations.

If our goodwill or amortizable intangible assets become impaired we could be required to record a significant charge to earnings.

Under GAAP, we review our goodwill and amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. GAAP requires us to test for goodwill impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include declines in stock price, market capitalization or cash flows and slower growth rates in our industry. We could be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets were determined, negatively impacting our results of operations.

Changes in tax rules and regulations, or interpretations thereof, may adversely affect our effective tax rates.

We are a U.S.-based multinational company subject to tax in multiple U.S. and foreign tax jurisdictions. A significant portion of our foreign earnings for the current fiscal year were earned by our Irish subsidiaries. In addition to providing for U.S. income taxes on earnings from the United States, we provide for U.S. income taxes on the earnings of foreign subsidiaries unless the subsidiaries' earnings are considered permanently reinvested outside the United States. While we do not anticipate changing our intention regarding permanently reinvested earnings, if certain foreign earnings previously treated as permanently reinvested are repatriated, the related U.S. tax liability may be reduced by any foreign income taxes paid on these earnings.

Our income tax expense has differed from the tax computed at the U.S. federal statutory income tax rate due primarily to discrete items and to earnings considered as permanently reinvested in foreign operations. Unanticipated changes in our tax rates could affect our future results of operations. Our future effective tax rates could be unfavorably affected by changes in the tax rates in jurisdictions where our income is earned, by changes in or our interpretation of tax rules and regulations in the jurisdictions in which we do business, by unanticipated decreases in the amount of earnings in countries with low statutory tax rates, or by changes in the valuation of our deferred tax assets and liabilities. The United States, countries in the EU and other countries where we do business have been considering changes in relevant tax, accounting and other laws, regulations and interpretations, including changes to tax laws applicable to

corporate multinationals such as Adobe. These potential changes could adversely affect our effective tax rates or result in other costs to us.

In addition, we are subject to the continual examination of our income tax returns by the U.S. Internal Revenue Service (“IRS”) and other domestic and foreign tax authorities, including a current examination by the IRS of our fiscal 2010, 2011 and 2012 tax returns. These tax examinations are expected to focus on our intercompany transfer pricing practices as well as other matters. We regularly assess the likelihood of outcomes resulting from these examinations to determine the adequacy of our

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provision for income taxes and have reserved for potential adjustments that may result from the current examinations. We cannot provide assurance that the final determination of any of these examinations will not have an adverse effect on our operating results and financial position.

If we are unable to recruit and retain key personnel, our business may be harmed.

Much of our future success depends on the continued service, availability and performance of our senior management. These individuals have acquired specialized knowledge and skills with respect to Adobe. The loss of any of these individuals could harm our business, especially in the event that we have not been successful in developing adequate succession plans. Our business is also dependent on our ability to retain, hire and motivate talented, highly skilled personnel across all levels of our organization. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense in many areas where our employees are located. If we are unable to continue to successfully attract and retain key personnel, our business may be harmed. Effective succession planning is also a key factor for our long-term success. Our failure to enable the effective transfer of knowledge and facilitate smooth transitions of our key employees could adversely affect our long-term strategic planning and execution.

We believe that a critical contributor to our success to date has been our corporate culture, which we have built to foster innovation, teamwork and employee satisfaction. As we grow, including from the integration of employees and businesses acquired in connection with previous or future acquisitions, we may find it difficult to maintain important aspects of our corporate culture, which could negatively affect our ability to retain and recruit personnel who are essential to our future success.

Our investment portfolio may become impaired by deterioration of the financial markets.

Our cash equivalent and short-term investment portfolio as of March 4, 2016 consisted of corporate bonds and commercial paper, U.S. agency securities and U.S. Treasury securities, foreign government securities, money market mutual funds, municipal securities, time deposits and asset-backed securities. We follow an established investment policy and set of guidelines to monitor and help mitigate our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes.

Should financial market conditions worsen in the future, investments in some financial instruments may pose risks arising from market liquidity and credit concerns. In addition, any deterioration of the capital markets could cause our other income and expense to vary from expectations. As of March 4, 2016, we had no material impairment charges associated with our short-term investment portfolio, and although we believe our current investment portfolio has little risk of material impairment, we cannot predict future market conditions or market liquidity, or credit availability, and can provide no assurance that our investment portfolio will remain materially unimpaired.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Below is a summary of stock repurchases for the three months ended March 4, 2016. See Note 9 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase program.

Period	Shares Repurchased	Average Price Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Approximate Dollar Value that May Yet be Purchased Under the Plans ⁽¹⁾
(in thousands, except average price per share)				
Beginning repurchase authority November 27—January 1, 2016				\$1,613,226
Shares repurchased January 2, 2016—January 29, 2016	418	\$91.51	418	\$(38,226)
Shares repurchased January 30—March 4, 2016	544	\$91.85	544	\$(50,000) ⁽²⁾
Shares repurchased	543	\$83.30	543	\$(45,238) ⁽²⁾
Total	1,505		1,505	\$1,479,762

In January 2015, the Board of Directors approved a new stock repurchase program granting authority to repurchase ⁽¹⁾ up to \$2 billion in common stock through the end of fiscal 2017. The new stock repurchase program approved by our Board of Directors is similar to our previous \$2 billion stock repurchase program.

In December 2015, we entered into a structured stock repurchase agreement with a large financial institution ⁽²⁾ whereupon we provided them with a prepayment of \$150 million. As of March 4, 2016, \$54.8 million of the prepayment remained under this agreement.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

Pursuant to Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012, which added Section 13(r) to the Securities Exchange Act of 1934, as amended, we are required to disclose in our annual or quarterly reports whether we or any of our affiliates knowingly engaged in certain activities, transactions or dealings relating to Iran or with individuals or entities subject to sanctions under U.S. law.

During our first quarter of fiscal year 2016, we determined that a representative of the Paris branch of Bank Melli purchased a year-long subscription to Adobe Export PDF, a software service we provide. On January 16, 2016, Bank Melli was removed from the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") Specially Designated National List; however, it remains an entity whose property and interests in property must be blocked by U.S. persons pursuant to Executive Order 13599. Upon further investigation and verification of the identity of the entity, we promptly deactivated the account.

Adobe's total revenue from this transaction was 24.34€, which is approximately U.S. \$27.00 at the exchange rate for U.S. dollars on the transaction date of February 2, 2016. We are unable to determine the net profits attributable to this transaction, but such net profits would be less than the total revenue. Adobe does not intend to continue this activity in the future, and we are reviewing our internal compliance policies and processes to determine how to prevent a

reoccurrence. Furthermore, we have voluntarily disclosed this matter to OFAC and intend to cooperate fully with regulatory inquiries, if any.

ITEM 6. EXHIBITS

The exhibits listed in the accompanying “Index to Exhibits” are filed or incorporated by reference as part of this Form 10-Q.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ADOBE SYSTEMS INCORPORATED

By: /s/ MARK GARRETT
Mark Garrett
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)

Date: March 30, 2016

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SUMMARY OF TRADEMARKS

The following trademarks of Adobe Systems Incorporated or its subsidiaries, which may be registered in the United States and/or other countries, are referenced in this Form 10-Q:

Adobe

Acrobat

Behance

Creative Cloud

Fotolia

Reader

All other trademarks are the property of their respective owners.

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference**		Exhibit Number	SEC File No.	Filed Herewith
		Form	Filing Date			
3.1	Restated Certificate of Incorporation of Adobe Systems Incorporated	8-K	4/26/11	3.3	000-15175	
3.2	Amended and Restated Bylaws	8-K	10/30/12	3.1	000-15175	
4.1	Specimen Common Stock Certificate	10-Q	6/25/14	4.1	000-15175	
4.2	Form of Indenture	S-3	1/15/10	4.1	333-164378	
4.3	Forms of Global Note for Adobe Systems Incorporated's 4.750% Notes due 2020, together with Form of Officer's Certificate setting forth the terms of the Note	8-K	1/26/10	4.1	000-15175	
4.4	Form of Global Note for Adobe Systems Incorporated's 3.250% Notes due 2025, together with Form of Officer's Certificate setting forth the terms of the Note	8-K	1/26/15	4.1	000-15175	
10.1A	Amended 1994 Performance and Restricted Stock Plan*	10-Q	4/9/10	10.1	000-15175	
10.1B	Form of Restricted Stock Agreement used in connection with the Amended 1994 Performance and Restricted Stock Plan*	10-K	1/23/09	10.3	000-15175	
10.1C	Form of Restricted Stock Unit Agreement used in connection with the Amended 1994 Performance and Restricted Stock Plan*	10-K	1/26/12	10.13	000-15175	
10.2A	1996 Outside Directors Stock Option Plan, as amended*	10-Q	4/12/06	10.6	000-15175	
10.2B	Forms of Stock Option Agreements used in connection with the 1996 Outside Directors Stock Option Plan*	S-8	6/16/00	4.8	333-39524	
10.3	1997 Employee Stock Purchase Plan, as amended*	10-Q	6/24/15	10.3	000-15175	
10.4A	2003 Equity Incentive Plan, as amended*	8-K	4/10/15	10.1	000-15175	
10.4B	Form of Stock Option Agreement used in connection with the 2003 Equity Incentive	8-K	12/20/10	99.4	000-15175	

Plan*

10.4C	Form of RSU Grant Notice and Award Agreement pursuant to the 2003 Equity Incentive Plan*	8-K	1/28/15	10.6	000-15175
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Exhibit Number	Exhibit Description	Incorporated by Reference**		SEC File No.	Filed Herewith
		Form	Filing Date		
10.4D	Form of Restricted Stock Agreement used in connection with the 2003 Equity Incentive Plan*	10-Q	10/7/04	10.11	000-15175
10.4E	2013 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/28/13	10.2	000-15175
10.4F	Form of Performance Share Award Grant Notice and Performance Share Award Agreement pursuant to the 2003 Equity Incentive Plan (applicable to the 2013 Performance Share Program)*	8-K	1/28/13	10.3	000-15175
10.4G	2014 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/29/14	10.2	000-15175
10.4H	Form of Performance Share Award Grant Notice and Performance Share Award Agreement pursuant to the 2003 Equity Incentive Plan (applicable to the 2014 Performance Share Program)*	8-K	1/29/14	10.3	000-15175
10.4I	2015 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/28/15	10.2	000-15175
10.4J	Form of 2015 Performance Share Award Grant Notice and Award Agreement pursuant to the 2015 Performance Share Program*	8-K	1/28/15	10.3	000-15175
10.4K	2016 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/29/16	10.2	000-15175
10.4L	Form of 2016 Performance Share Award Grant Notice and Award Agreement pursuant to 2016 Performance Share Program*	8-K	1/29/16	10.3	000-15175
10.4M	Form of Director Initial Grant Restricted Stock Unit Award Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.6	000-15175
10.4N	Form of Director Annual Grant Restricted Stock Unit Award Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.7	000-15175

10.4O	Form of Director Annual Grant Stock Option Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.8	000-15175
10.5A	2005 Equity Incentive Assumption Plan, as amended and restated*	10-Q	6/28/13	10.17	000-15175

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Exhibit Number	Exhibit Description	Incorporated by Reference**			SEC File No.	Filed Herewith
		Form	Filing Date	Exhibit Number		
10.5B	Form of Stock Option Agreement used in connection with the 2005 Equity Incentive Assumption Plan*	8-K	12/20/10	99.10	000-15175	
10.5C	Form of RSU Grant Notice and Award Agreement pursuant to the 2005 Equity Incentive Assumption Plan*	8-K	1/28/13	10.7	000-15175	
10.6	Retention Agreement between Adobe Systems Incorporated and Shantanu Narayen, effective December 5, 2014	8-K	12/11/14	10.20	000-15175	
10.7	Form of Indemnity Agreement*	10-Q	6/26/09	10.12	000-15175	
10.8A	Lease between Adobe Systems Incorporated and Selco Service Corporation, dated March 26, 2007	8-K	3/28/07	10.1	000-15175	
10.8B	Participation Agreement among Adobe Systems Incorporated, Selco Service Corporation, et al. dated March 26, 2007	8-K	3/28/07	10.2	000-15175	
10.8C	Master Amendment No. 2 among Adobe Systems Incorporated, Selco Service Corporation and KeyBank National Association dated October 31, 2011	10-K	1/22/13	10.13	000-15175	
10.9	Adobe Systems Incorporated Deferred Compensation Plan, as Amended and Restated* Credit Agreement, dated as of March 2, 2012, among Adobe Systems Incorporated and certain subsidiaries as Borrowers, The Royal Bank of Scotland PLC and U.S. Bank National	10-K	1/20/15	10.19	000-15175	
10.10A	Association as Co-Documentation Agents, JPMorgan Chase Bank, N.A., as Syndication Agent, Bank of America, N.A. as Administrative Agent and Swing Line Lender, and the Other Lenders Party Thereto	8-K	3/7/12	10.1	000-15175	
10.10B	Amendment to Credit Agreement, dated as of July 27, 2015, among Adobe Systems Incorporated and Bank of America, N.A. as Administrative Agent and Swing Line Lender and the Other Lenders Party Thereto	8-K	7/30/15	10.1	000-15175	

10.11A	Omniture, Inc. 1999 Equity Incentive Plan, as amended (the “Omniture 1999 Plan”)*	S-1	4/4/06	10.2A	333-132987
10.11B	Forms of Stock Option Agreement under the Omniture 1999 Plan*	S-1	4/4/06	10.2B	333-132987

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Exhibit Number	Exhibit Description	Incorporated by Reference**		SEC File No.	Filed Herewith
		Form	Filing Date		
10.11C	Form of Stock Option Agreement under the Omniture 1999 Plan used for Named Executive Officers and Non-Employee Directors*	S-1	6/9/06	10.2C	333-132987
10.12	Omniture, Inc. 2006 Equity Incentive Plan and related forms*	10-Q	8/6/09	10.3	000-52076
10.13	Omniture, Inc. 2007 Equity Incentive Plan and related forms*	10-K	2/27/09	10.9	000-52076
10.14	Omniture, Inc. 2008 Equity Incentive Plan and related forms*	10-K	2/27/09	10.10	000-52076
10.15	Demdex, Inc. 2008 Stock Plan, as amended*	S-8	1/27/11	99.1	333-171902
10.16	2013 Executive Annual Incentive Plan*	8-K	1/28/13	10.5	000-15175
10.17	2014 Executive Annual Incentive Plan*	8-K	1/29/14	10.5	000-15175
10.18	2015 Executive Annual Incentive Plan*	8-K	1/28/15	10.5	000-15175
10.19	2016 Executive Annual Incentive Plan*	8-K	1/29/16	10.5	000-15175
10.20	2016 Executive Cash Performance Bonus Plan*	8-K	1/29/16	10.4	000-15175
10.21	EchoSign, Inc. 2005 Stock Plan, as amended*	S-8	7/29/11	99.1	333-175910
10.22	TypeKit, Inc. 2009 Equity Incentive Plan, as amended*	S-8	10/7/11	99.1	333-177229
10.23	Auditude, Inc. 2009 Equity Incentive Plan, as amended*	S-8	11/18/11	99.1	333-178065
10.24	Auditude, Inc. Employee Stock Option Plan, as amended*	S-8	11/18/11	99.2	333-178065
10.25	Efficient Frontier, Inc. 2003 Stock Option/Stock Issuance Plan, as Amended and Restated*	S-8	1/27/12	99.1	333-179221
10.26	Nomination and Standstill Agreement between the Company and the ValueAct Group dated December 4, 2012	8-K	12/5/12	99.1	000-15175
10.27A	Behance, Inc. 2012 Equity Incentive Plan*	S-8	1/23/13	99.1	333-186143

10.27B	Amendment No. 1 to the Behance, Inc. 2012 Equity Incentive Plan*	S-8	1/23/13	99.2	333-186143
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Exhibit Number	Exhibit Description	Incorporated by Reference**		Exhibit Number	SEC File No.	Filed Herewith
		Form	Filing Date			
10.28	Neolane 2008 Stock Option Plan*	S-8	8/27/13	99.1	333-190846	
10.29	2012 Neolane Stock Option Plan for The United States*	S-8	8/27/13	99.2	333-190846	
10.30	Description of 2013 Director Compensation*	10-K	1/21/14	10.80	000-15175	
10.31	Description of 2014 Director Compensation*	10-K	1/21/14	10.81	000-15175	
10.32	Description of 2015 Director Compensation*	10-K	1/20/15	10.52	000-15175	
10.33	Description of 2016 Director Compensation*	10-K	1/19/16	10.32	000-15175	
10.34A	Aviary, Inc. 2008 Stock Plan, as amended*	S-8	9/26/14	99.1	333-198973	
10.34B	Form of Stock Option Grant Notice and Award Agreement pursuant to the Aviary, Inc. 2008 Stock Plan (Installment Vesting)*	S-8	9/26/14	99.2	333-198973	
10.34C	Form of Stock Option Grant Notice and Award Agreement pursuant to the Aviary, Inc. 2008 Stock Plan (Installment Vesting, Non-U.S.)*	S-8	9/26/14	99.3	333-198973	
10.35	Adobe Systems Incorporated 2014 Executive Severance Plan in the Event of a Change of Control*	8-K	12/11/14	10.1	000-15175	
31.1	Certification of Chief Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934					X
31.2	Certification of Chief Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934					X
32.1	Certification of Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934†					X
32.2	Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934†					X

101.INS	XBRL Instance	X
101.SCH	XBRL Taxonomy Extension Schema	X
101.CAL	XBRL Taxonomy Extension Calculation	X

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Exhibit Number	Exhibit Description	Incorporated by Reference**			SEC File No.	Filed Herewith
		Form	Filing Date	Exhibit Number		
101.LAB	XBRL Taxonomy Extension Labels					X
101.PRE	XBRL Taxonomy Extension Presentation					X
101.DEF	XBRL Taxonomy Extension Definition					X

* Compensatory plan or arrangement.

** References to Exhibits 10.11A through 10.14 are to filings made by Omniture, Inc.

† The certifications attached as Exhibits 32.1 and 32.2 that accompany this Quarterly Report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Adobe Systems Incorporated under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.