IFRS Revenue Recognition

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Safe harbor

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Basic revenue recognition criteria under IFRS

IAS 18, Par. 14:

“Revenue from the sale of goods shall be recognized when all the following conditions have been satisfied:

a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

c) the amount of revenue can be measured reliably;

d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.”
Exceptions from revenue recognition

IAS 18, Par. 16, 18:

• “If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognized. Examples:
  a) when the entity retains an obligation for unsatisfactory performance ... ;
  b) when the receipt of the revenue from a particular sale is contingent ... ;
  c) when the goods are shipped subject to installation ... ; and
  d) when the buyer has the right to rescind the purchase ... .”

• “Revenue is recognized only when it is probable that the economic benefits associated with the transaction will flow to the entity.”

Conclusion:
Only if benefits are not probable, „cash accounting“ has to be applied.
Measurement of revenue at fair value amount of cash or cash equivalent

IAS 18, Par. 11:

• “However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable.

• When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

• The difference between the fair value and the nominal amount of the consideration is recognized as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IAS 39.”
IAS 18 interpretation by all major audit firms

• Analysis of Annual Reports:
  revenue recognition regardless of payment terms
  • general accounting practice in Europe
  • all major audit firms gave unqualified opinions

• Analysis of technical literature:
  • „Payment streams are generally irrelevant for revenue recognition.“
    (Pilhofer/Bösser/Düngen, WPg 2010, p. 90)
  • „... US GAAP not be applied regarding deferred payment terms.“
    (Lüdenbach, IFRS- Kommentar, p. 1415)

• Software AG Accounting manual developed consulted by EY and audited by Group Auditor

Conclusion:
1. Revenue must be recognized regardless of payment terms
2. US GAAP rules are not to be applied under IFRS
Conclusion on IFRS interpretation

- IFRS rules strictly applied in line with general interpretation

- US GAAP not be applied regarding treatment of deferred payment terms

Outlook:
New Revenue Recognition standard (scheduled for Q3/2013, IASB and FASB):
- IFRS rules regarding the impact of payment terms will remain unchanged
  - “... the Board...rejected differentiating the licenses based on... pattern of payments...” (IFRS Implementation Guidance BC389)
- Impact of payment terms will be addressed stating that payment terms will not affect revenue recognition
- New standard will be a joint standard for IFRS as well as US GAAP. Consequently, US GAAP preparers will have to change their accounting practice.
Operations
Trade receivables

(in €m)

- Long term trade receivables
- Short term trade receivables

Years:
- 2008
- 2009
- 2010
- 2011
- 2012
- H1 2013
License revenue share from deals > € 1m
Split of large license deals (> € 1m) by business line

(percentage of total number of large deals)
Trade receivables

(in €m)

- Un invoiced Consulting Services
- Receivables with additional future payment advice note (new system)
- Receivables with previous payment advice note (new system)

1) Based on information from previous SAP-system

2) Based on information current SAP-system (rollout completed 2010: ≈40%, 2011: ≈60%, since 2012: >90%)
Uninvoiced consulting services - receivables in % of total revenue

1.9% 1.9% 1.9%

Software AG* Tibco* IBM*

Core peer group

1.3%

Sage** SAP**

“not material”

* company data 2012
** source: Credit Suisse
Trade receivables in % of revenue

- License:
  - 2007: 93%
  - 2008: 97%
  - 2009: 126%
  - 2010: 107%
  - 2011: 108%
  - 2012: 107%

- Total:
  - 2007: 36%
  - 2008: 37%
  - 2009: 40%
  - 2010: 31%
  - 2011: 29%
  - 2012: 33%
Factoring impact on Cash Flow (FY)

(in €m)

- Factoring impact
- Operating Cash Flow without factoring impact

2008 2009 2010 2011 2012
Business view

• Multi-year deals are common practice in the entire software sector.
• Customers trade expected discounts for extended payment terms.
• Customers with cash-based accounting (public sector) prefer deferred payment terms to simulate depreciation.
• Financial impact: low interest rates (current financial market environment) favor longer payment terms over discounts on price.
• Peers simulate the approach by adding a bank loan to the transaction.
• Multi year history proves high creditworthiness of our customers. No relevant write offs for receivables with deferred payment terms.

Conclusion:
Economic competitive advantage for Software AG (IFRS) over peers (US GAAP) following the same commercial practice.