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**

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Conclusion on IFRS interpretation

- IFRS rules strictly applied in line with general interpretation

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

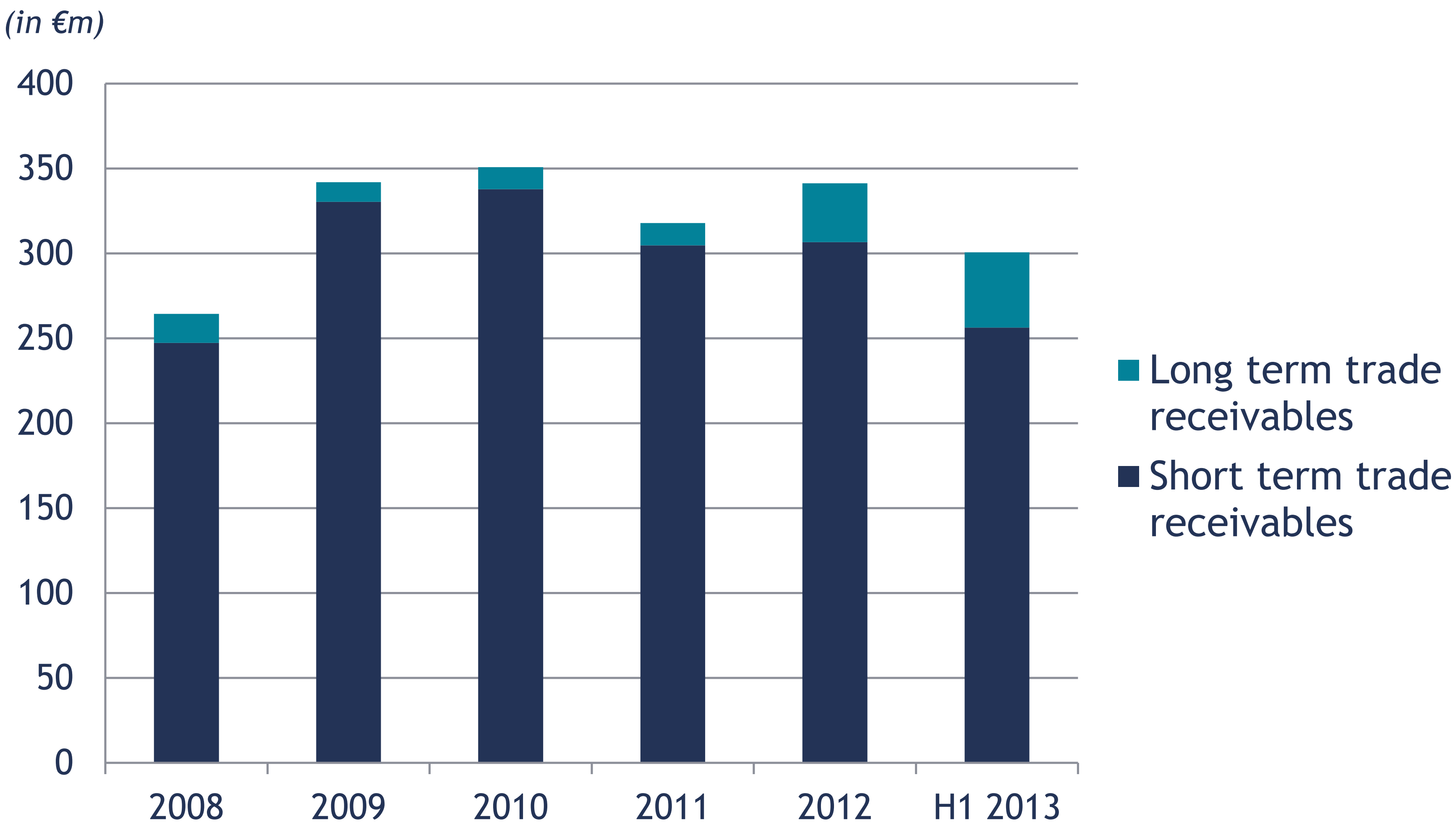
Outlook:

New Revenue Recognition standard (scheduled for Q3/2013, IASB and FASB):

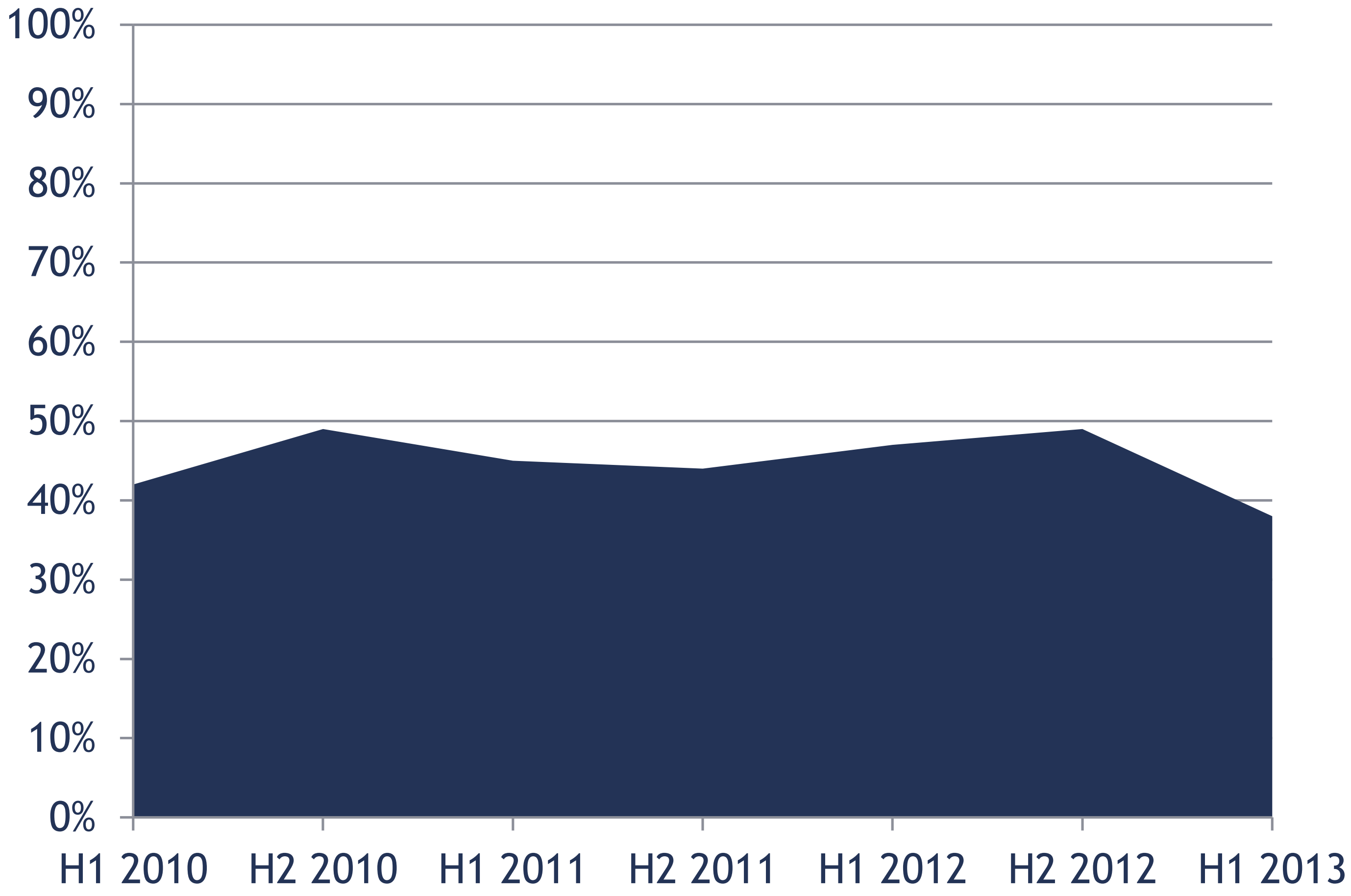
- IFRS rules regarding the impact of payment terms will **remain unchanged**
  - "… the Board…rejected differentiating the licenses based on… pattern of payments…" (IFRS Implementation Guidance BC389)
- Impact of payment terms will be addressed stating that **payment terms will not affect revenue recognition**
- 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



License revenue share from deals > € 1m



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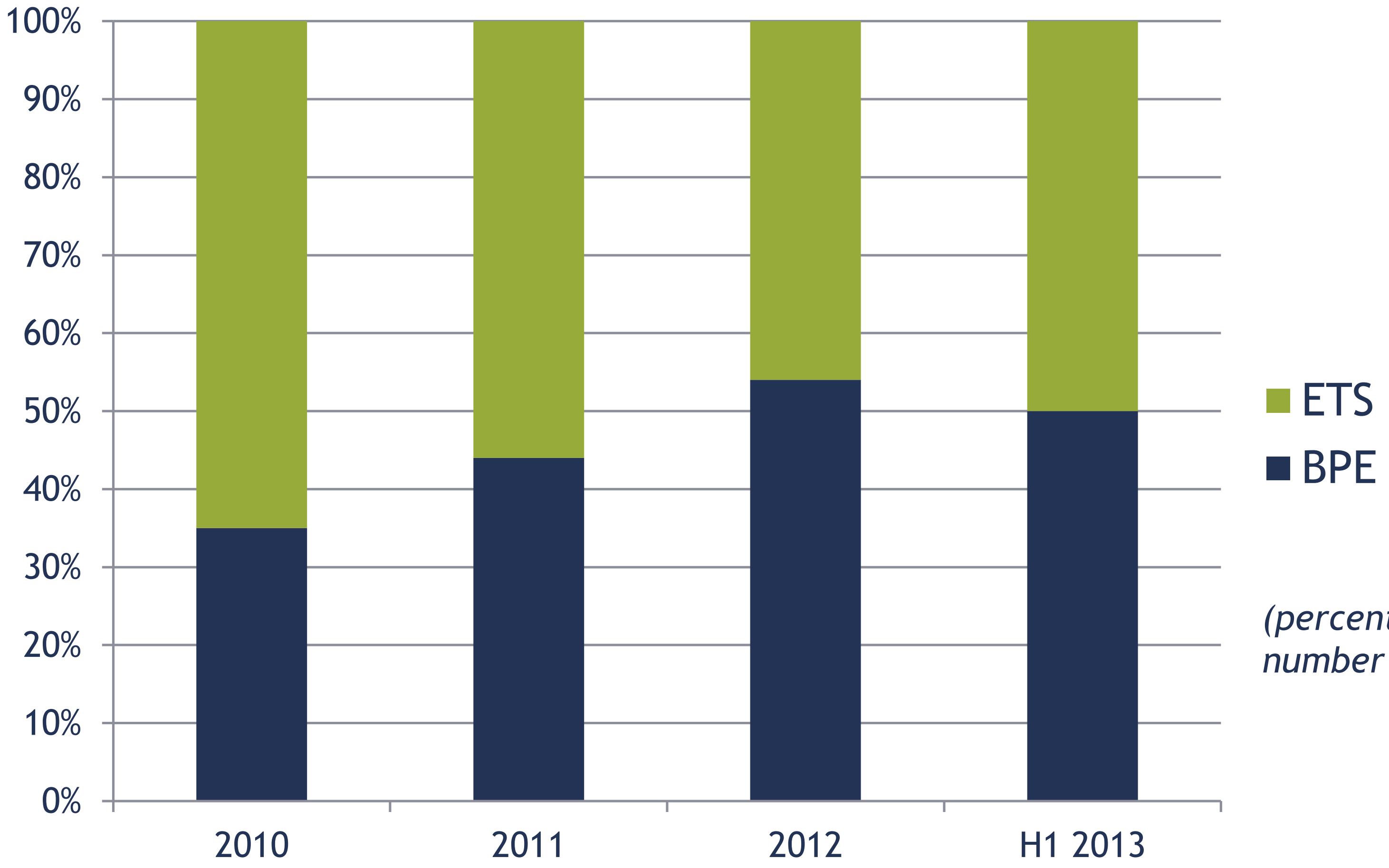
Split of large license deals (> € 1m) by business line



(percentage of total number of large deals)

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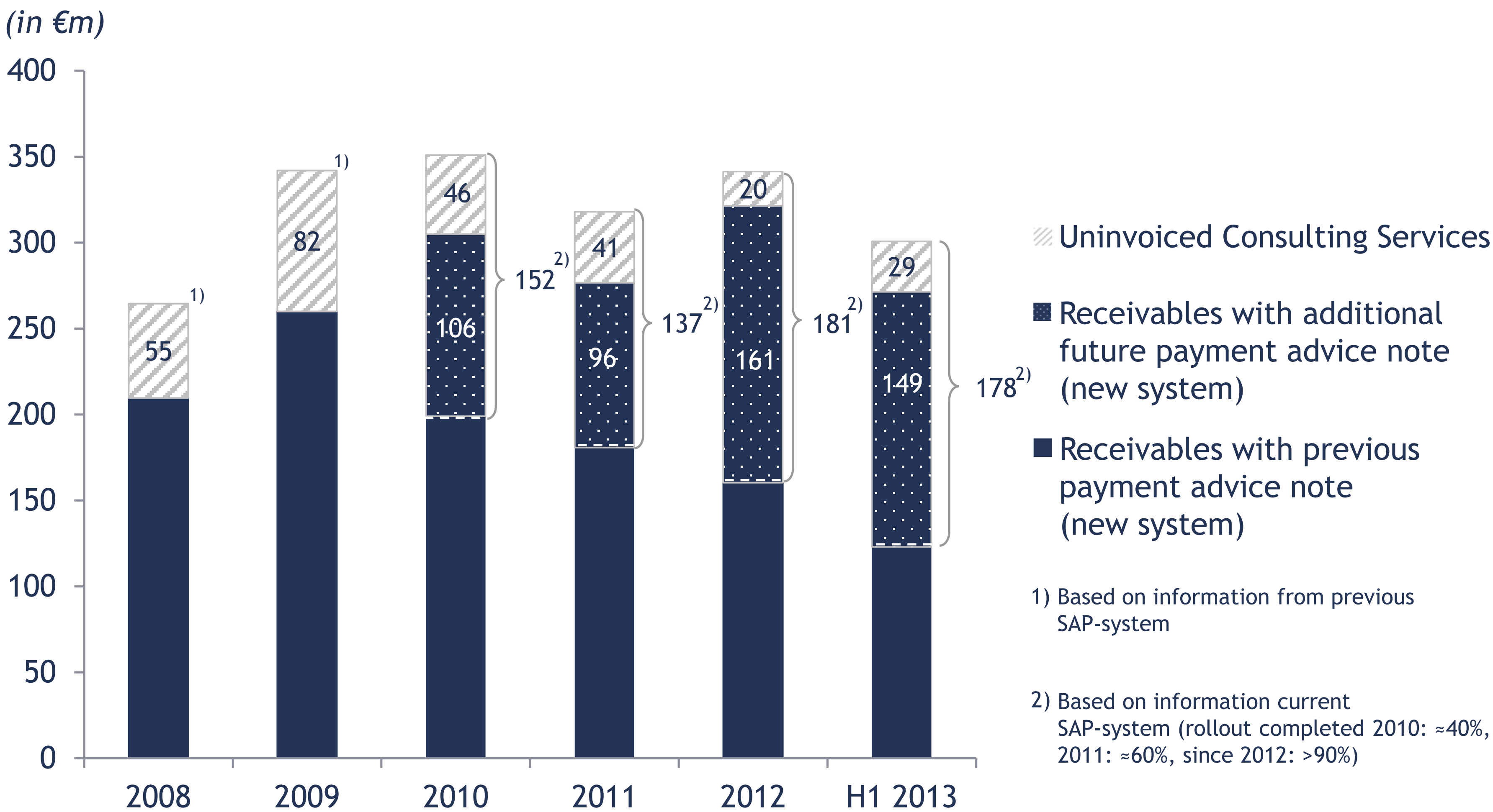
Trade receivables



1) Based on information from previous SAP-system

2) Based on information current SAP-system (rollout completed 2010: ≈40%, 2011: ≈60%, since 2012: >90%)

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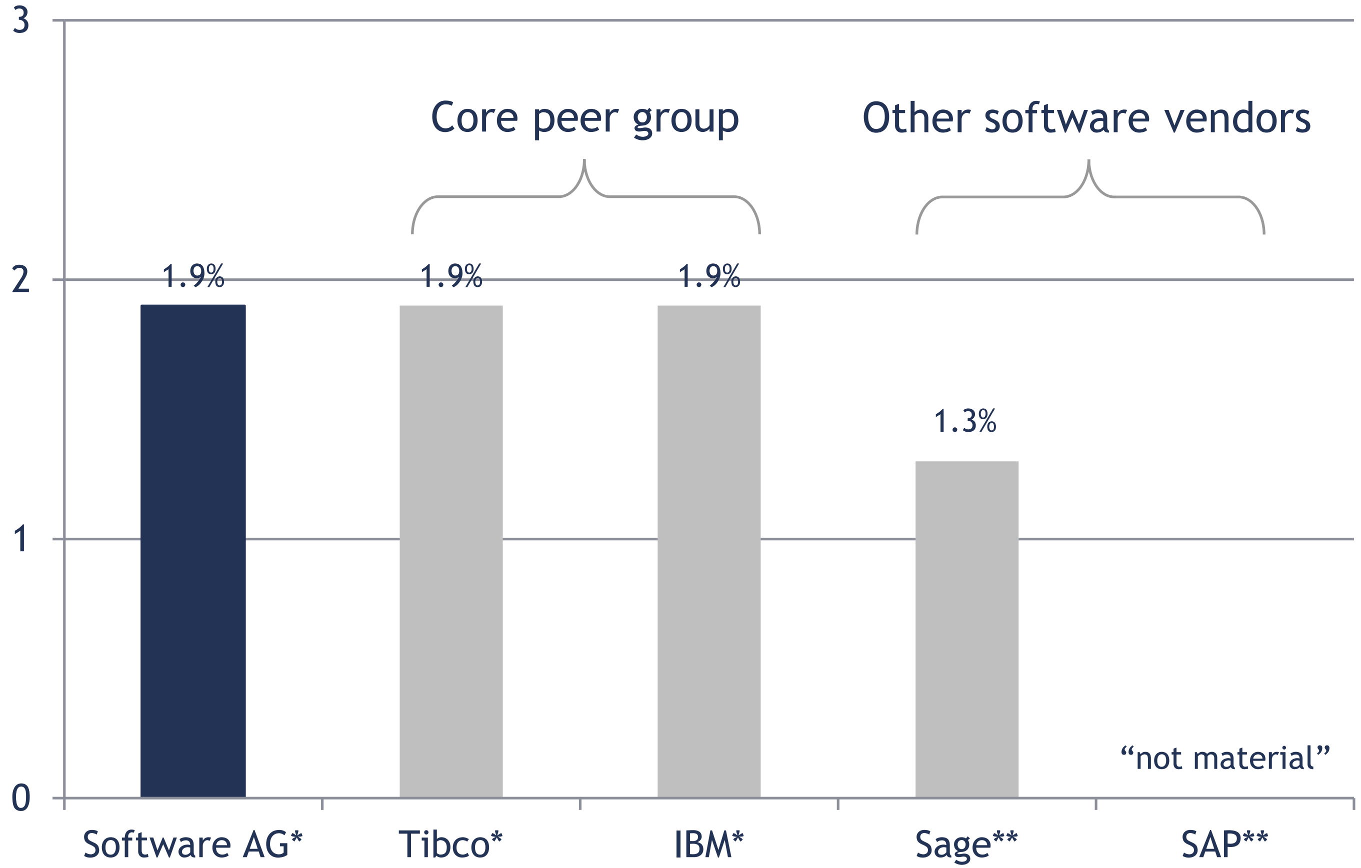
Uninvoiced consulting services – receivables in % of total revenue



*) company data 2012
**) source: Credit Suisse

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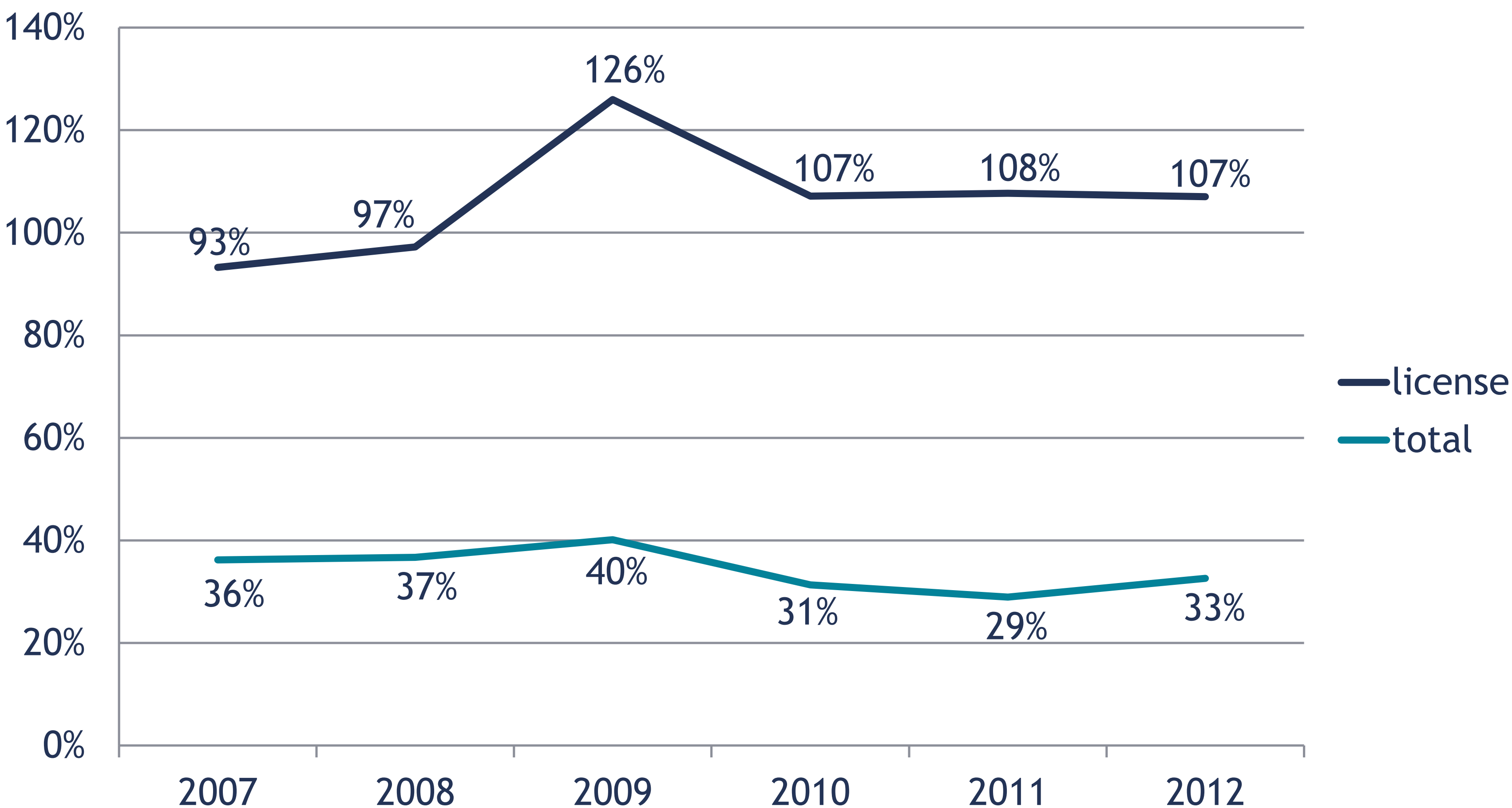
Trade receivables in % of revenue



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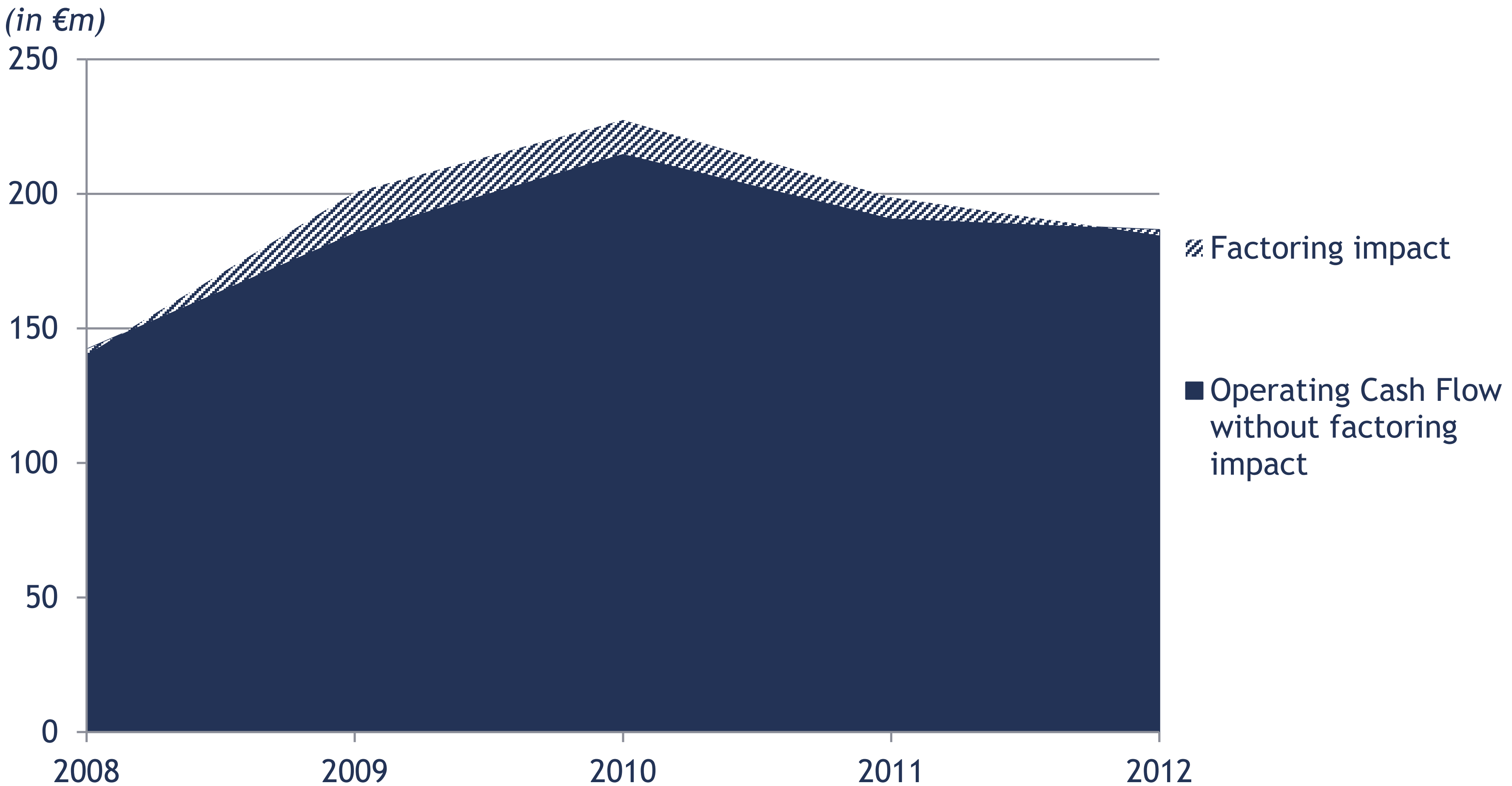
Factoring impact on Cash Flow (FY)



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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.

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