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Comment Letter No. 386

Software AG
Uhlandstraße 12
64297 Darmstadt
Deutschland/Germany
Phone: +49 (0) 6151 92-0
Fax +49 (0) 6151 92-1191

Group Executive Board
Karl-Heinz Streibich (Vorsitzender),
Arnd Zinnhardt, Mark Edwards,
David Broadbent, Josef Bommersbach,
Dr. Wolfram Jost, Kamyar Niroumand,
Ivo Totev

www.softwareag.com

Software AG | Postfach 13 02 51 | 64242 Darmstadt | Germany

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Contact **Josef Ganter** <josef.ganter@softwareag.com>
Phone **+49 (0) 6151 92-2807** Fax **+49 (0) 6151 92-2835**

Subject: Software AG's comments to the Exposure Draft (ED) "Revenue from Contracts with Customers

Dear Madam/Sir,
We appreciate the opportunity to submit the following comment letter in relation to the Exposure Draft (ED) "Revenue from Contracts with Customers". While we believe that it makes sense to standardize the revenue recognition rules and this ED is a big step in doing so, we also believe that some of the general concepts within the ED would not be appropriate in all industries and/or types of business activity.
As a software company, we focus on licensing company specific intangible rights and related services and some of the proposed changes in the ED could have material implications on the revenue classification and timing for these various contractual elements. We would like to make sure that we can maintain proper accounting for the economic substance of the various transactions that we enter into and are not forced to account for these transactions in a way that would not provide our shareholders with a true and fair view of our results. In addition, from an internal management standpoint, it is crucial that we have financial information that best shows the clearest picture of our results so we can make the proper management decisions necessary to steer our business in directions necessary to achieve targeted growth and profitability.

Please find our comments in Appendix 1 to some of the questions posed by the Boards in the ED. We would be happy to discuss any of these points in more detail upon request.

Yours Sincerely

Josef Ganter
SVP Finance
Software AG

Peter Loiselle
Senior Director Finance Operations
Software AG

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Question 3: Do you think that the proposed guidance in paragraphs 25-31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

Software AG's Answer to Question 3: We think that the transfer of control question needs to be looked at separately for a good and for a service. According to the definition of transfer of control in paragraph 26 of the ED, *"a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. Control includes the ability to prevent other entities from directing the use of, and receiving the benefit from directing the use of, and receiving the benefit from, a good or service"*. For the satisfaction of performance obligations through the transfer of a good, it is much easier to establish the point in time in which the customer obtains control of the good. For example, when a customer purchases software, we may send a download link and a code key so that the customer can instantly download the software and begin getting the benefits from that software. However, with a service that is performed over a certain time period, the performance to satisfy the obligation is taking place on a continuous basis but the customer is not yet in a position to reap all of the benefits of the asset being built. Although the ED gives indicators when control has been transferred, which includes transfer of continuous control through a "service that is customer specific" that would "require the customer to pay for any work to date", we believe that the focus should be more on the continuous progress of the service than on the concept of control. One problem with this indicator is with the legal requirement for the customer to pay for any work to date if necessary or requested. First and foremost, different jurisdictions would have different laws relating to the ownership of work in process and the requirement to pay as you go. Secondly, the focus would then be on the contractual form of deal instead of the substance of the transfer through performance of the services. This is because it would be necessary to legally transfer the asset to date and legally bind the customer to payment for that asset. This would most likely lead to entities wishing to make monthly changes to long term construction contracts, which customers will not necessarily agree to and is usually not how such deals are structured in actuality. The normal practice of getting paid based on milestones would penalize those entities who are not able to make monthly changes to their contracts and would create a situation in which two companies performing the exact same service could have widely different results just because of the different contractual forms of their agreements with their respective customers. We therefore believe that this continuous approach based on the progress of the service, e.g. through percentage of completion, would be the most appropriate method of accounting and would produce results that, compared to the situation described above, are both more accurate in measuring the performance of the obligation as well as provide results that are more comparable between entities.

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Question 5: Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognises when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

Software AG's Answer to Question 5: We do not agree that a customer's credit risk should affect how much revenue is recognized as opposed to whether it should be recognized in the first place. We believe there are many reasons why it would be inappropriate to net the credit risk of a customer with the revenue to provide a net revenue amount. Some of these reasons are as follows:

- In most cases, a customer would either pay 100% of a receivable or 0 (digital view). The probability weighted amount (analogue view) will most likely never be collected. For example, there are two customers (A and B) with different credit ratings who purchase software. Customer A purchases €1 Mio of software and has an AA credit rating. Because of the good credit rating, collectability is deemed to be 90% since 100% can never be guaranteed without securing the proper collateral. Customer B purchases €3 Mio of software and has a very poor credit rating. Collectability for customer B is deemed to be 40%. Under the proposed rules, €900K of revenue would be recognized for customer A and €1.2 Mio would be recognized for customer B (total of €2.1 Mio). In actuality, the probable amount (i.e. best estimate) that will be collected will be €1 Mio. According to the current rules, the €1 Mio would be booked as revenue since collection from Customer B is improbable. This is in line with the real probable amount of cash inflows.
- The sale of goods and services and the non collection of receivables are, in our opinion, two separate events. Recognizing revenue should occur once a performance obligation has been fulfilled. Non collection of a receivable could be because of many reasons. The situation that caused non collection may not have existed at the onset of the arrangement and is not necessarily related to the performance obligation being fulfilled (e.g. receivable is due in three months and customer has financial difficulty two months after deal is signed)
- Netting two income statement accounts (revenue + bad debt expense) would provide less accurate information to the readers of the financial statements than presenting each income statement item gross. A reader of the financial statements would not have the necessary information to determine how risky the business is that the entity enters into.
- Although paragraph 38 of the ED stipulates that the transaction price be reasonably estimated, determining the probability of collection at the outset of the agreement may be very subjective and could lead to an entity being either more or less conservative in their judgements. In addition, the information available to make such an evaluation at the outset of a contract varies significantly between public and private companies. There is much more information available on publicly held companies, while the majority of information on private companies is limited to what they supply to the credit reporting services like D&B. Accordingly one could have difficulty evaluating two companies of the same size if one was publicly held and the other privately held due to the amount of information available
- According to paragraph 43 of the ED, even if the full accounts receivable amounts are collected, any revenue non collection allowances originally not booked as revenue will only be posted as "income" at the bottom of the income statement. This will distort the total revenue to date and not provide the readers of the financial statements with a true and fair view of the revenue.
- Posting different revenue amounts for each deal than will most likely be collected will lead to an administrative burden that will be very difficult to monitor. Moreover, it would be necessary to majorly retool all current systems to allow for this discrepancy.

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Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases.

Software AG's Answer to Question 7: We generally agree with the principal of allocating the transaction price to the performance obligations based on stand-alone selling prices but only if these stand-alone selling prices approximated reliable fair value of the various performance obligations. As previously stated, as a software company, we license company specific intangible rights and related services. For the intangible rights, the discounts can vary widely (from a 99% discount to a high premium) and for consulting services, for example, the discounts are very limited and the normal selling prices are generally close to the list prices. We can afford to give such discounts for the intangible rights because margins are practically infinite (highest variable costs are sales commissions based on sales volume). Consulting services, on the other hand, are very labour intensive, the competition is high since there are many players in the marketplace and this, in turn, results in comparatively low margins. Moreover, the discounts on some of the software licenses need to be kept high to match market expectations and keep pace with the competition. A customer may be disappointed when getting only a 20% discount if purchasing some types of enterprise software where the competition generally sells at 50% discounts or more but may be very happy with the same discount if the purchase was made for software that is always sold by all vendors at or near list price. To solve this general issue, Software AG has implemented the residual method in which consulting services are first deducted from the transaction price and the residual is allocated to license/maintenance (maintenance being a % of the net license fee). Under the proposed new rules in the ED, if we weren't able to segregate the consulting services portion of the deal in a multiple element arrangement containing licenses, maintenance and consulting services, the revenue calculation based on relative "list prices" could lead to a loss on the consulting services side and too much license revenue being booked upfront. If the suggestion would be to estimate the "selling price" of the licenses in each deal instead of using objective list prices, there may be too much subjectivity in such estimations on a deal by deal basis and could lead to different entities being either more or less conservative in their judgements; possibly making comparability of results between these different entities difficult. Moreover, from a management perspective, such an artificial loss in consulting services could also lead to decision making that prevents taking on otherwise profitable projects or encourages further developing certain software products that are on the verge of being obsolete within the marketplace. We therefore believe that in the situation where reliable fair market value of some performance obligations are available but not for all of them, the residual method would provide a much more accurate financial presentation and would not lead to premature upfront realization of revenue.

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Question 10: The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed requirements will meet that objective? Why or why not?

Software AG's Answer to Question 10: It is our understanding that the convergence of US GAAP and IFRS is suppose create a standard that promotes a more accurate reporting of revenue for the various performance obligations in customer contracts as well as delivers improved comparability of results between companies. In order to provide even more transparency of a company's financial picture and outlook, certain additional information in the form of disclosure requirements could be beneficial to a reader of financial statements. However, since the disclosure requirements in the ED are so vast and burdensome, it is our opinion that not only the reader will be baffled by the information overload but also the preparer of such information will be overwhelmed with the amount of data that needs to be gathered. Moreover, the cost of trying to attain such information through the necessary development of new systems as well as additional personnel to deal with the additional data entry at the contract level would be much more than the benefit of having this information. Although the ED states that this information should be aggregated or disaggregated so that information shall not be obscured, this information would still need to be prepared at the contract level in the initial step. We believe that a disaggregation of revenue as described in the ED is a realistic disclosure that would provide a reader with key information concerning revenue sources. The reconciliation of contract balances on the other hand, would not only be impractical and extremely costly to prepare but would also not necessarily provide any additional information that would influence a reader of financial statements opinion on the past or future performance of the company. In regards to the disclosures on performance obligations, we believe that it is reasonable to provide general information concerning the accounting policies of the company but not provide information at the contract level. We also believe that for onerous performance obligations, it is reasonable and informative to provide aggregate data for the sum of onerous performance obligations as a whole but reporting such information at the contract level would be tedious and costly and would not provide added value to the readers of the financial statements. All other general disclosures that may provide insight into the company's financial policies and practices seem reasonable from a preparer's standpoint.

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Software AG's comments relating to paragraph 53: This paragraph stipulates that if there are subsequent changes in the transaction price, this price change should be allocated to all performance obligations on the same basis as at contract inception and changes in stand-alone selling prices should not be taken into consideration. We believe that instead of simply allocating this changed amount to all performance obligations, it's necessary to look at the reason for the change and adjust revenue to the specific performance obligations relating to the change. An example is as follows… A deal for licenses and a fixed priced consulting services project for an amount of €100K is entered into in January. These performance obligations can't be segregated from each other. At the onset of the deal, it was determined that €50K should be booked as license revenue and €50K should be booked as consulting services revenue. In March, the customer decides to add major functionality to the specs of the project and the additional effort would lead to a significant increase of the fixed price consulting project in the amount of €50K. Assuming that revenue was allocated based on the stand-alone selling prices at contract inception, this would mean that ½ of the revenue would be allocated to licenses and the other ½ to consulting services. There would be no additional licenses granted but license revenue would be booked. Moreover, for the extra work required to handle the change request, there would most likely be a loss because of the thin margins associated with such services. We believe that such an allocation would not correctly represent the true economic substance of the transaction. In conclusion, we think that such a blanket revenue calculation for transaction price changes should take into consideration the cause of the change.