1987 Annual Report

Software AG Systems, Inc. Selected Financial Data

The following selected financial data are derived from the consolidated financial statements of the Company for the years ended May 31, 1983 through 1987. Information for the last three years should be read in conjunction with the consolidated financial statements and related notes included elsewhere herein.

(In Thousands, except per share amounts)

Years Ended May 31,	1987	1986	1985	1984	1983
Selected Statement of Operations Da	ata:				
Revenues	\$67,244	\$65,760	\$52,264	\$41,127	\$30,044
Income Before Cumulative Effect					
of Change in Accounting	4,332	8,545	6,733	5,856	1,249
Net Income	4,332	8,545	5,140	5,856	1,249
Income per Common Share Before Cumulative Effect of Change					
in Accounting	.74	1.45	1.12	.95	.20
Net Income per Common Share	.74	1.45	.86	.95	.20
Pro Forma Amounts Assuming the Change in Accounting is Applied Retroactively:					
Revenues	\$67,244	\$65,760	\$52,264	\$39,566	\$31,522
Net Income	4,332	8,545	6,733	5,115	1,953
Net Income per Common Share	.74	1.45	1.12	.83	.32
Selected Balance Sheet Data:					
Working Capital	\$37,316	\$32,919	\$24,329	\$23,381	\$15,187
Total Assets	62,330	59,537	48,767	51,155	35,883
Long-Term Debt	186	309	475	155	252
Total Stockholders' equity	44,663	41,843	33,092	32,792	26,868

Software AG

Software AG Systems, Inc. (the Company), through its subsidiary, Software AG of North America, Inc., develops, markets, and supports an integrated system of software products and consulting services, providing its customers with a complete range of applications development and information management capabilities. Software AG technology operates independently of computer hardware or operating systems, and is used on mainframe computers as well as departmental-sized systems and PC-based computer networks.

Throughout its 15-year history, the Company has successfully marketed and supported products developed under cross-licensing agreements with Software AG of Darmstadt, West Germany. The Company benefits from its own development efforts, as well as the extensive research and development activities of Software AG, Darmstadt, other Software AG companies, and distributors around the world. Within the worldwide activities of Software AG, the Company services and supports a product line of more than 35 software tools in the U.S. and, through licensing agreements with distributors, in the Far East, Southeast Asia, Central and South America, Canada, Africa, Australia, and Israel.

Together, Software AG Systems, Inc., and Software AG, Darmstadt, represent an international cooperative affiliation which provides products and complementary services to a diverse worldwide community of more than 2500 computer installations.

From our origins as the providers of superior data base management products; through the offering of complete fourth generation applications development systems; to the delivery of such systems, along with human skill and expertise in their use; we have become the supplier of complete, strategic software solutions, well-equipped to enter into full partnerships with our customers.

The Software AG Mission: To team with our customers in achieving long-term success, by delivering outstanding software solutions and professional excellence to accelerate the implementation of computer-based systems, profitably.

To Our Stockholders:

Fiscal 1987 was a year of significant activity and achievement for Software AG Systems, Inc. Revenues for the year ended May 31, 1987 totalled \$67.2 million, compared to revenues of \$65.8 million during 1986. Net income was \$4.3 million, compared to \$8.5 million last year. Earnings per share were \$.74, compared to per share earnings of \$1.45 in 1986. The Company continued to operate without debt and maintained excellent liquidity, as measured by cash reserves and investments exceeding \$21 million.

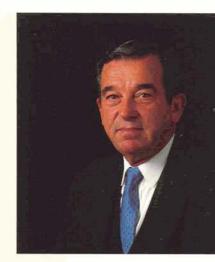
In the early part of the year, we initiated several new marketing programs, expanded the Company's sales and support force, and made investments to extend the services we offer to our customers. The new expenses associated with these investments were not fully offset by domestic revenues during the first part of the year. Our fourth quarter income, however, was higher than earlier quarters, partly attributable to these earlier investments; our improved financial performance at year's end resulted in modest gains in total annual revenues.

Significant changes within the data base management system (DBMS) marketplace have also had an effect on this year's financial performance. This market, which has historically generated a substantial portion of the Company's total revenues, has seen increased penetration by a number of vendors in recent years, including hardware manufacturers who have introduced and marketed new DBMS strategies.

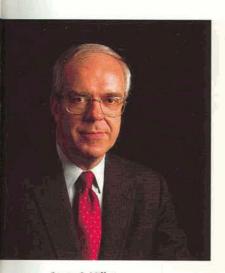
This increased activity, while verifying our early recognition of the value of the DBMS in the development of practical, computer-based business solutions, has created confusion among buyers and delays in purchasing decisions. Extensive debates on DBMS architecture standards have compounded this confusion, further lengthening the sales cycle for new acquisitions. We are pleased to note, however, that the performance of Software AG's complete set of application development products, proven in data processing environments around the world, is an increasingly important factor in buyers' decisions.

Throughout this period of increased competition among systems software suppliers, our information management technologies have continued to evolve, proving their performance with new and existing users. As illustration of the continuing acceptance of our products, ADABAS, Software AG's DBMS, was recognized this year as one of only a handful of software products to have ever garnered more than \$250 million in worldwide sales.* The forthcoming release of ADABAS 5 later this year will

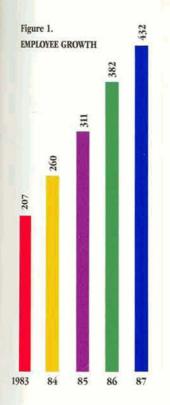




John Norris Maguire Chairman of the Board



Stuart J. Miller President and Chief Executive Officer



reflect further, significant investments in the development of new technologies for the management of information in high-volume, production environments.

The enthusiastic response among analysts and users alike to this year's release of NATURAL 2 also demonstrates the growing recognition of the value of Software AG technologies. NATURAL 2 represents a major advance in fourth generation technology for the development of computer applications and systems which work independently of operating environments.

Software AG has also made major investments in developing new products and services designed to satisfy the broader needs of the users in our marketplace. In fact, Software AG introduced more enhancements and additions to its product and service line in 1987 than in any prior year. These investments will continue to provide new sources of revenue, generated from:

- the growing line of Software AG products for use on Digital Equipment Corporation's VAX computers;
- increases in sales of additional products which serve as functional extensions of our core products, through an expanded sales force and a new telemarketing department;
- · new business generated by our on-site consulting groups; and
- the continuing record-breaking performance of our international distributors.

Most importantly, we have continued to hire and develop experienced personnel to deliver and support these new offerings (Figure 1).

We believe the development of these important business areas in the past year, and the foundations we have laid for creation of other new growth opportunities in this and coming years, are investments which will continue to ensure our long-term success.

A Broader Strategy

We have experienced much less of the negative effects associated with the computer industry slowdown of the last two years than many of our competitors. In fact, our cumulative revenue increases during this period would constitute a significant rate of growth under any circumstances. For this continuing strength, we credit several technological advances and longterm strategies we initiated several years ago. The most important of these strategies resulted from our recognition in the mid-1970s of the value of increasing the productivity of programming personnel. This need for new levels of productivity led to the introduction of NATURAL, Software AG's fourth generation language (4GL), in 1979. Since its introduction, NATURAL has helped to increase the productivity of applications developers and end users alike, and has gained increased recognition as an advanced, fourth generation systems development tool.

The release of NATURAL 2, a major restructuring of this fourth generation technology, was the most significant of Software AG's product announcements in many years. The welcome which NATURAL 2 has received from users and analysts confirms our belief that the full "tool set" which NATURAL 2 and its related products provide represents the most advanced systems development environment available.

Another of the strategic decisions which has helped to maintain our consistent, long-term growth was prompted by a realization in the early 1980s that the reductions in spending on new mainframes would increase the demand for computers designed to provide departmental, distributed

functions for smaller groups of users.

Research and development of full-production versions of ADABAS and NATURAL for use on the VAX line of computers from Digital Equipment Corporation (DEC) began in 1980. Both ADABAS(VMS) and NATURAL(VMS) were delivered by 1984; sales of products to the DEC marketplace have grown from 3% of our total domestic revenue in 1986 to 10% in 1987. With an extensive family of products for VMS environments planned for release by the end of this year, we will continue to advance in the marketplace of DEC users, which is estimated to contain more than 40,000 distinct sites in the U.S. alone (Figure 2).

Another area of growth for the Company will be in providing our own expertise and methodologies to our customers, helping them derive further productivity from our technologies. The immediate successes of Software AG's Custom Solutions and Professional Services consulting groups, which provide a wide range of assistance to users of our products, indicates a considerable demand for such advanced services. We expect these groups will provide important contributions in 1988, and that they will generate increasing portions of our revenue during the next five years. More importantly, their efforts will continue to strengthen the strategic relationships we have established with our customers.

DEC VAX VERSUS
IBM MAINFRAMES*
(1981-1987)

45

40

35

30

(SQUWSJOHLL VI)

16,304

15

1,200

DEC

0

8, 28, 38, 41, 58, 71

Figure 2.

Copyright © 1987 by CMP Publications, Inc. 600 Community Drive, Manhasset, NY 11030 Reprinted with permission from InformationWEEN

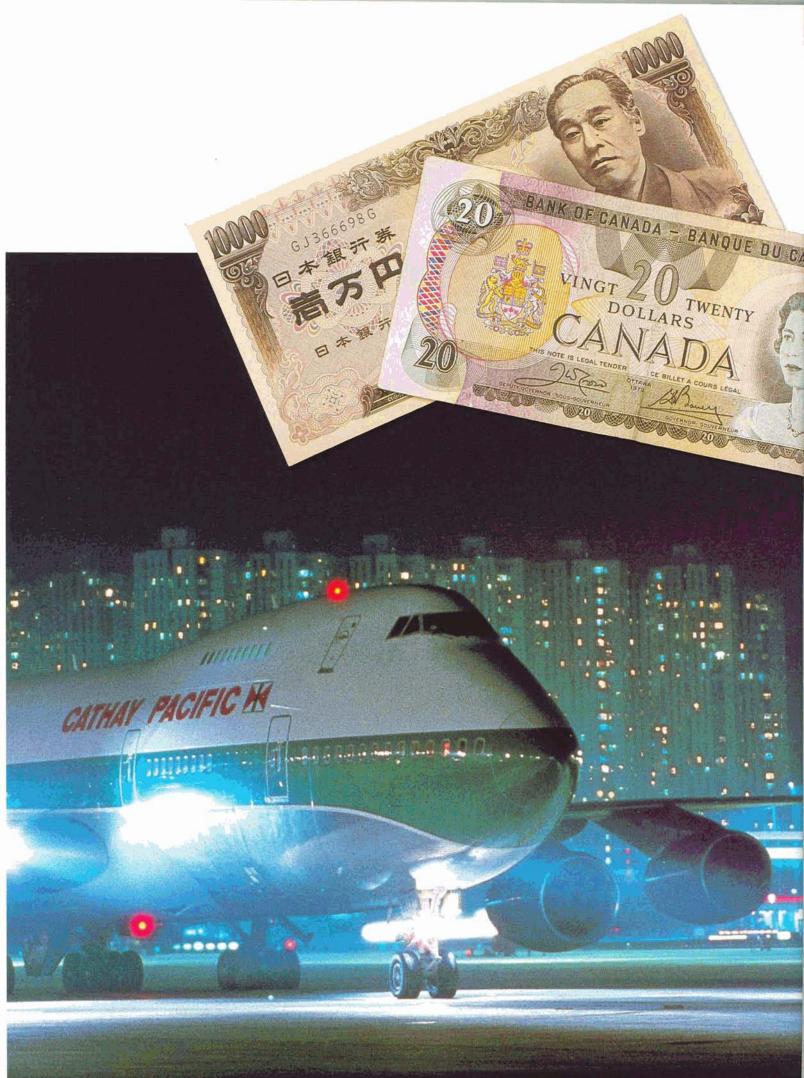
A Successful Philosophy

The decisions which generate these and other growth opportunities for Software AG are made on the basis of a philosophy of the Company which has often been articulated in our 15-year history: we are committed to continue providing *strategic*, practical software solutions, in the form of integrated products, support, and services, in close partnership with our users; not to attempt to become a "supermarket" of disparate, unrelated software utilities. Illustration of this emphasis is provided by the increasing portions of our domestic revenue which are generated from services which complement our products, including education, maintenance, and consulting activities performed by personnel using our technologies. The strategic alliances which result from delivery of these additional Software AG service businesses to our customers will continue to generate larger percentages of our revenue.

In the essay that follows, we offer a closer look at some of the key products and services which the Company makes available to its users. This essay reflects the philosophy, activities, and accomplishments of all of the people and organizations which together represent Software AG solutions throughout the world. As in past annual reports, we are proud to rely on the experiences of our users to describe our successes in these arenas. We thank *all* of our users for serving as partners in our success.

We also offer thanks to our other partners: to Software AG employees around the world, whose hard work ensures our continued progress; to our shareholders, for their confidence in the value of our endeavors; and to the members of our Board of Directors, for their unstinted support and assistance.

John Norris Maguire Chairman of the Board Stuart J. Miller President and Chief Executive Officer



Global Solutions



In a business world where national boundaries are rapidly dissolving, only to be replaced by a single worldwide economy, companies are becoming increasingly aware of their need for organized information that is available wherever they conduct business.

Software AG, with more installations worldwide than any other independent DBMS/4GL vendor, has for years offered the global presence sought by growing numbers of corporations. We are the only independent software company with major positions in all worldwide markets. Our core products, ADABAS and NATURAL, have gained acceptance at more than 2500 computer sites around the world, and are currently used by over 60,000 programmers and applications developers. The other components of our product line are also in increasing demand among our international customers, as witnessed by the outstanding sales performance of our international distributors in 1987.

These distributors are independent companies that have successfully established leading positions in their respective markets. The Software AG end user products distributed by these organizations are available in six international languages, consistent with our efforts to adapt our technologies to meet the unique needs of diverse markets.

Our international distributors also have the capability to develop new technologies in response to market needs, thereby augmenting the principal research and development efforts performed by Software AG. Because these new products are developed using ADABAS and NATURAL structures and syntax, they fit easily into the worldwide Software AG product line.

This unique network of service and support offices around the world provides an international pool of technological and marketing talent which benefits all users of Software AG products, and furthers our position as the one truly international systems software organization.

With more than 7000 employees around the globe, Cathay Pacific has established a reputation for punctuality, reliability, and superior service. From its headquarters and hub in Hong Kong, Cathay Pacific operates a network of routes to key business cities in Asia, Europe, North America, the Middle East, China and Australia. Some of these routes involve long baul, nonstop flights from Hong Kong to destinations such as London, Frankfurt and Vancouver. In Hong Kong, Cathay Pacific uses ADABAS, NATURAL, PREDICT, NET-PASS and other Software AG products for many important applications, including their financial, engineering, maintenance, in-flight service, and flight operational systems. Software AG products also support Cathay Pacific's popular frequent flyers program, the Marco Polo Club.





NATURAL 2

Our 15-year history has been one of technological innovation. The introduction of ADABAS in 1971; NATURAL, in 1979; the development of more than 35 fully integrated tools — all have served as milestones to help mark Software AG's progress. This pattern continued in 1987 with the release of several major products, including:

ADABAS SQL, an SQL interface to ADABAS for third generation languages;

 REVIEW 2, which measures the performance of ADABAS and our online, data communications management system, COM-PLETE; and

 SUPER NATURAL 2, our end user computing tool, which now includes manipulation capabilities for user data.

Perhaps the most significant product introduction in our recent history, however, was this year's release of NATURAL 2. This technology completes the transition of our product philosophy to one based on providing highly automated development tools to all users of information, regardless of their experience levels.

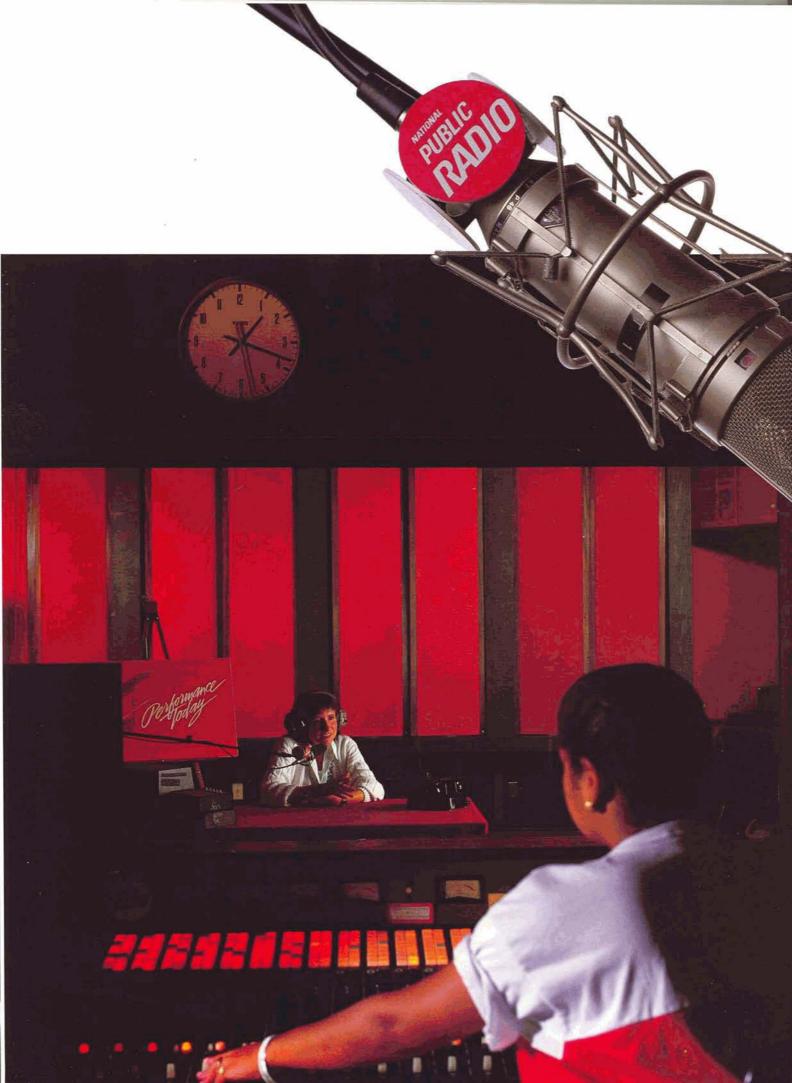
NATURAL 2 allows users to create systems and applications which could not be created with COBOL, or with other fourth generation languages. NATURAL 2 supports various file structures, such as VSAM and DL/1. Our use of NATURAL 2 to develop other end user tools will allow the benefits of this technology to be felt throughout our product line.

Most importantly, its open architecture is designed so that NATURAL 2 will operate independently of the data management, hardware, or operating systems being used. This portability continues to provide Software AG with advantageous positions as our industry evolves. For one example, our strategy of providing products which are fully integrated within open architectures predates current industry efforts to provide common environments for applications development and communications. In a related example, IBM's new 9370 series of mid-sized computers provides another area for growth: both NATURAL and ADABAS already operate under Virtual Machine (VM) and DOS SP2, widely regarded as the operating systems of choice for 9370 machines.

The ability to be used as a "standalone" technology, teamed with its greatly expanded functionality, places NATURAL 2 well ahead of competing applications development systems. The forthcoming availability of NATURAL 2 in the new market comprising users of IBM's DBMS, DB2, planned for later this year, will secure its position as the premier systems development technology.

With more than 6000 employees and 39 manufacturing plants around the country, Inland Container Corporation is one of the leading producers of corrugated boxes in the world. At its Indianapolis, Indiana, beadquarters, Inland uses NATURAL 2 for all new systems development, and also is converting other applications to NATURAL 2-based programs. NATURAL applications at Inland include those for administration, finance, and billings; NATURAL 2 was used to create a quoting/costing system used by Inland's sales representatives.





The Digital Advantage

The explosive growth in popularity of the VAX series of computers from the Digital Equipment Corporation (DEC) constitutes one of the most significant developments in the recent history of the computing industry, and heralds a dramatic shift in the basic buying philosophies and patterns of the industry as a whole. As managers of computer hardware and software focus on more cost-efficient, flexible ways of delivering information technology to increasingly diverse groups of users, interest in DEC's VAX line of computers will continue to grow. Software AG technologies and services are in position to take full advantage of the opportunities provided by this trend.

Software AG's recognition of the viability of such an approach to computing, as well as our basic philosophy to make our products operational in a multitude of environments, led in 1981 to initial design and development of products geared to provide high performance information management capabilities for large networks of VAX end users. With many of the same features — open architectures, power, and flexibility — that have made the VAX series popular, both ADABAS and NATURAL have been accepted by thousands of users in VAX environments around the world.

In 1987, we released several important products in the VAX marketplace, including PREDICT, an active data dictionary, and NET-WORK, which uses various communication protocols to allow for remote access and update of data bases on both VAX and IBM systems. Other Software AG activities in the DEC arena in 1987 have included:

- establishment of the Digital Programs group, a sales and marketing team which will further expand our focus in the DEC/VAX marketplace;
- augmenting our DEC sales efforts with new sales and support staff in every Software AG office, and with new marketing and advertising programs;
- dedication of classrooms and education staff for users of our VMS products; and
- development of VMS-specific courseware for our computer-based training system, NATURAL ELITE.

Our past efforts in the DEC arena will continue to serve as preface for future plans. By the end of fiscal 1988, we will have more than 12 major products available in the VAX marketplace, including SUPER NATURAL, ADABAS SQL, NATURAL GRAPHICS, and several networking products to serve a variety of communication requirements.

For National Public Radio (NPR), a non-profit membership organization based in Washington, D.C. which provides programming and support services to more than 350 member radio stations around the country, Digital Equipment Corporation's VAX computers bave satisfied the need for a flexible, state-of-the-art computer system. In turn, Software AG's ADABAS and NATURAL bave fulfilled the need for software that supports automation of NPR's key divisions. NPR bas used ADABAS to create large data bases which are heavily used by numerous personnel, yet still conserve storage resources. For NPR's Programming Division, Software AG products support the complex distribution procedures for programs including "Performance Today," NPR's daily, two-bour musical celebration of the arts. shown here in production.

Federal Systems

Software AG has been a primary provider of systems software to the U.S. federal government for 15 years, having developed and maintained accounts at nearly 90 distinct agency sites during this period. Our products have also found wide usage by many of the prime contractors (or integrators) who projects and missions, many of which are defense-related. It is in this particular arena where many of which are defense-related. It is in this line are especially valuable, including the connectivity we offer between the Department of Defense standard for applications development and holds. This year, we founded with ADABAS, Including the connectivity mad our other products. This year, we founded the Software AG Federal Systems division to

enhance the productivity of our relationships in the federal marketplace. In its first year, the Federal Systems division has continued to build new relationships within federal agencies and the integrator community. In close cooperation with third party vendors who use our products, we introduced our first vertical application product this year, the Federal Personnel Management System (FPMS), which is currently used by the Department of Defense.

The future activities of Software AG Federal Systems will include the creation of federal consulting teams modeled after our Professional Services and Custom Solutions groups. These and other efforts in the federal marketplace will benefit from the fact that many government departments have already made long-term, strategic commitments to Software AG, by establishing ADABAS and NATURAL as agency standards for information management and applications development. This wide usage of our products within the federal sphere, combined with our new marketing efforts and consulting services, will make the federal marketplace one of our strongest growth areas

sion than originally planned. eim noimie space station misresources would be required to nadditional on-board power was a determination that these comprehensive studies mission support. One result of mal requirements necessary for o determine power and therton to perform critical analyses Johnson Space Center in Housof the Space Station team at the saəquan əqi (q pəsn uəəq svq Shace Station in 1996, ADABAS Launch of the permanent U.S. In preparation for the initial operations as well.

Jor launch and Jiight control

nautics and Space Administration (NASA). Increasingly,

Software AG technology is also relied upon by NASA contractors

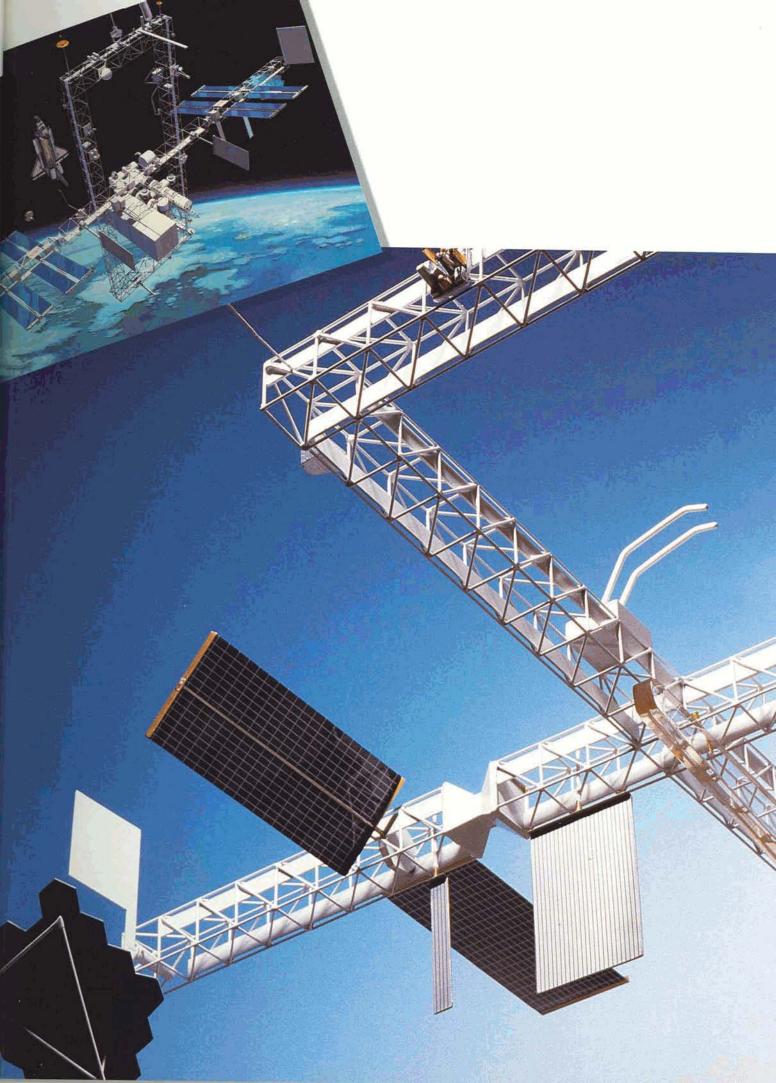
orest innoital editor dero-

o support agency-wide administrative systems and calibration

pesu simpond emmfos sueisas

Since 1985, ADABAS and NATURAL bave been the standard







Shared Expertise

At its data center in Cherry Hill, New Jersey, the R.H. Donnelly Co. bas relied on Software AG's Professional Services teams to perform a variety of services. Primarily known as publishers of the yellow page directories for phone companies, R.H. Donnelly bas tapped Professional Services to analyze training programs, make recommendations for new programs and personnel, and fine-tune the performance of systems which are used to support yellow page sales and distribution.

New Jersey Transit is a statewide agency which provides and coordinates bus and passenger rail service in New Jersey. NJT's Information Resources Management department turned to Software AG's Custom Solutions group for quick development of an in-house system to bandle the distribution of bus and rail tickets to more than 20,000 subscribers who purchase such tickets by mail. Using ADABAS, NATURAL, and other Software AG products, the Custom Solutions team developed NJT's MAILTIK to manage this ticket distribution system. MAILTIK also provides for credit card payment, and supports enhanced ticket printing for easier ticket identification by rail/bus crews and for protection against unauthorized ticket duplication. In addition, MAILTIK serves New Jersey Transit as a "model system" on which future applications will be based.

As the demand for well-trained personnel is felt within more and more data processing centers, the quality and range of on-site consulting services made available by system software suppliers play an increasingly important role in making the most of existing systems. Software AG's two business groups, Professional Services and Custom Solutions, provide just this kind of expertise.

Consisting of experts who are extensively trained in the use of our products, these groups provide a wide range of services, including project management, system design, performance tuning, training, and, in the case of Custom Solutions, actual development of applications tailored to meet the unique needs of our customers.

This range of assistance is designed to answer the specific needs of our clients. New users' needs often include data base administration assistance, on-site training, and coding analysis; established users require advanced performance tuning, large systems design, system conversion assistance, and other, more involved services. Regardless of the experience levels of the clients served by our consultants this year, Professional Services and Custom Solutions have provided the kind of high quality service which our industry has come to demand.

Through the efforts of these two groups, we will continue to demonstrate to our customers how they can use our applications development methodologies to generate their own systems and create their own solutions. To this end, we are extending our Custom Solutions organization to our field offices, to provide for closer contact with our customers. Sharing this expertise with our users not only increases their productivity; it promotes the usage of our technologies by increasing our users' familiarity with them. Most importantly, by helping to build self-reliance within information management organizations, we establish the foundations for long-lasting business partnerships.

Strategic Solutions

For more than 15 years, Software AG has dedicated its resources to development of a fully integrated spectrum of products and services that provide strategic solutions at all levels of computing. With our current progress in Federal Systems, the DEC marketplace, consulting services, and our new fourth generation technologies, we hold enviable positions in attractive markets all over the world — and benefit from the inherent advantages of a product line of complementary technologies, proven by thousands of users.

While we expect significant returns on the investments we have made in these areas, we continue to plan for long-term viability with new technologies. Our exploration of new approaches to data base management will be reflected in this year's release of ADABAS 5, which will be used as the basis for advanced technologies such as knowledge-based systems, integrated text management, and distributed processing. The coming year will also see major advances in our related office automation and communication capabilities, with new releases of CON-NECT, an office management system, and NET-PASS, a new VTAM session manager.

NATURAL 2 will continue to serve Software AG as a platform for development of other technologies geared for applications developers and end users, such as C.A.S.E. (Computer-Aided Systems Engineering) products, and advanced methodologies to instruct users on new ways to approach systems development. In this way, NATURAL 2 serves both as a culmination of our efforts to provide for truly integrated information management and applications development, and as the first step toward a future of totally automated systems creation, where entire computer systems can be conceived, prototyped, and designed without a single line of code.

In an industry marked by change, we continue to base our activities on proven quantities. Software AG's ongoing efforts to deliver new technologies and services are, as always, focused clearly on fulfilling the needs of our users. As we have demonstrated during the last 15 years, the partnerships a company establishes with its customers provide the soundest of all foundations for future success.



Management's Discussion and Analysis of Financial Condition and Results of Operations

Liquidity and Capital Resources

The Company believes that it has substantial cash and cash equivalents at fiscal year-end which are adequate to meet its needs for the current year. The current ratio is 4.4 to 1. Cash flow is enhanced by regular collection of accounts receivable and lease contracts receivable. Long-term lease contracts receivable of \$2,951,000 at fiscal year-end provide an additional source of future cash flow. The Company also has a line of credit of \$14,000,000 with a commercial bank. The line may be used for general working capital purposes and as an interim financing for acquisitions. There have been no borrowings under this agreement. Uses of cash are currently confined primarily to expenditures for staff, staff facilities, travel, communications, and administration. Some cash payments from distributors are collected by Software AG, Darmstadt, West Germany (SAG) on behalf of the Company and are used by SAG to offset royalties due them.

During fiscal 1987, the Company, through its subsidiary, Systems Software I, Inc., entered into three (3) real estate partnerships. These partnerships were formed to develop the Company's new corporate headquarters and to ensure expansion options within two office buildings in the same complex. The Company anticipates that its capital expenditure requirements for its new headquarters building will total approximately \$5,000,000. Approximately \$2,100,000 of those funds will be required during fiscal 1988 with the remaining amount to be spent during the following year. Additionally, the Company is contingently liable for the completion of the construction of the new building which is projected to cost approximately \$16,000,000. This funding requirement will be handled via a construction loan, which is scheduled to be available by the end of the first quarter of fiscal 1988, and ultimately by permanent financing following completion of the building.

Results of Operations

Fiscal 1987 Compared to Fiscal 1986

Revenues increased 2% to \$67,244,000. This modest increase in revenue is principally attributable to a 26% increase in Technical Service fees and a 22% increase in international sales, which offset an 18% decrease in domestic license fees. The decrease in license fees was attributable to the overall slowdown in the computer software industry. Interest income from short-term investments contributed \$1,655,000 (2% of revenues) compared to \$2,222,000 (3% of revenues) for fiscal 1986. This decrease was the result of the Company shifting more of its funds into tax exempt municipal securities, with pretax equivalent interest rates less than other investments. Had the Company maintained its past investment mix the interest income for the year would have been comparable to that of the prior year.

Salaries, Wages and Commissions increased 17% to \$19,855,000. The increase is the result of 50 net new employees and salary rate increases.

Royalty Fees increased 20% to \$14,157,000. The increase is primarily due to increased Technical Service fees and international revenues.

Other Operating Expenses increased 26% to \$26,588,000. The increase is principally attributable to increased personnel, promotion, facilities, depreciation, and professional fee expenses.

Income Before Income Taxes decreased to \$6,644,000, as revenues did not increase proportionately to increased expenses.

The effective income tax rate in fiscal 1987 decreased to 34.8% from 46.4% for fiscal 1986. The decrease is principally due to increased foreign tax credits and the increased investment in municipal securities where interest is exempt from federal and state income taxes.

Fiscal 1986 Compared to Fiscal 1985

Revenues increased 26% to \$65,760,000. In general, the increase in revenue is principally attributable to a greater volume of licenses. Technical Services revenues increased by 46% due to the greater volume of licenses and a general increase in the annual Technical Services rate for most products from 10% to 12%. Interest income on short-term investments contributed \$2,222,000 (3%) to revenues.

Salaries, Wages and Commissions increased 34% to \$17,020,000. The increase is the result of an increase in 71 net new employees, an increase of 23% over the previous year, salary increases and commissions on higher sales.

Royalty Fees increased 23% to \$11,750,000. The increase is primarily due to increased product revenues.

Other Operating Expenses increased 22% to \$21,065,000. The increase is principally attributable to the expenses associated with the increase in personnel. In addition, the Company accrued a \$560,000 contribution to its Employees' Retirement Benefit Plan.

Income Before Income Taxes increased to \$15,925,000 compared to \$12,693,000 in fiscal 1985 primarily due to an increase in revenue.

The effective income tax rate in fiscal 1986 decreased to 46.4% compared to a 47.0% rate for fiscal 1985. The decrease is principally due to the investment of funds in municipal securities where the interest is exempt from both federal and state income taxes.

Fiscal 1985 Compared to Fiscal 1984

Revenues increased 27% to \$52,264,000. In general, the increase in revenue is principally attributable to a greater volume of licenses. Effective for fiscal 1985, the Company changed its accounting for contract revenue. The new policy is to recognize revenue at the time the product is installed as opposed to its former policy which had been to recognize 90% of the revenue at contract execution and the remaining 10% at installation. As a result of this change in accounting, revenues were \$932,000, less than they would have been if the change had not been made. International revenues increased 39% to \$11,839,000 resulting from a greater volume. Interest income on short-term investments contributed \$2,133,000 (4%) to revenues. Revenues from new products were 5% of total revenue.

Salaries, Wages and Commissions increased 32% to \$12,745,000. The increase is the result of the hiring of 51 employees, an increase of 20% over the previous year, salary increases and commissions on higher sales.

Royalty Fees increased 35% to \$9,569,000. The increase is primarily due to a higher growth rate of international sales revenue, whose royalty rate is higher than other royalty-related revenues.

Other Operating Expenses increased 28% to \$17,257,000. The increase is attributable, in part, to the expenses associated with the increase in personnel and the opening of four sales offices during the year. In addition, the Company accrued a \$330,000 contribution to its Employees' Retirement Benefit Plan. The Company made no contribution in 1984.

Income Before Income Taxes increased to \$12,693,000 compared to \$10,936,000 in fiscal 1984 primarily due to an increase in revenue.

The effective income tax rate in fiscal 1985 increased to 47.0% compared to a 46.5% rate for fiscal 1984. The increase is principally due to an increase in Income Before Income Taxes while the amount of foreign and investment tax credits available were approximately the same as in 1984.

Consolidated Statements of Income

Software AG Systems, Inc. and Subsidiaries For the Three Years Ended May 31, 1987 (In Thousands except per share amounts)

	1987	1986	1985
Revenues			
Product and License Fees (Notes 10 and 14)	\$38,778	\$41,799	\$33,293
Customer Services Fees (Note 10)	22,707	18,298	13,574
Interest Earned (Notes 2 and 3)	2,909	3,597	3,519
Other	2,850	2,066	1,878
Total Revenues	67,244	65,760	52,264
Costs and Expenses			
Salaries, Wages and Commissions	19,855	17,020	12,745
Royalty Fees (Note 5)	14,157	11,750	9,569
Other Operating Expenses (Note 11)	26,588	21,065	17,257
Total Costs and Expenses	60,600	49,835	39,571
Income Before Income Taxes and Cumulative Effect of			
Change in Accounting	6,644	15,925	12,693
Income Taxes (Note 6)	2,312	7,380	5,960
Income before Cumulative Effect of Change in Accounting	4,332	8,545	6,733
Cumulative Effect of Change in Accounting for Recognizing			
Contract Revenue, net of Deferred Income Taxes of			
\$1,380 (Note 14)	<u> </u>	_	(1,593)
Net Income	\$ 4,332	\$ 8,545	\$ 5,140
Income per Common Share Before Cumulative Effect of			
Change in Accounting	\$ 0.74	\$ 1.45	\$ 1.12
Cumulative Effect of Change in Accounting for Recognizing			
Contract Revenue, net of Tax (Note 14)			(0.26)
Net Income per Common Share	\$ 0.74	\$ 1.45	\$ 0.86
Number of Shares Used to Compute Income Per			
Common Share	5,855	5,893	6,011

Consolidated Balance Sheets

Software AG Systems, Inc. and Subsidiaries May 31, 1987 and 1986

(In	Thousands	except	share	amounts)
---	----	-----------	--------	-------	---------	---

	1987	1986
Assets		
Current Assets:		
Cash and Short Term Investments (Note 2)	\$ 21,609	\$ 24,752
Accounts Receivable, net (Note 3)	22,116	17,841
Current Portion of Lease Contracts Receivable (Note 3)	3,323	3,753
Other Current Assets	1,213	1,543
Total Current Assets	48,261	47,889
Lease Contracts Receivable (Note 3)	2,951	4,043
Property, Equipment and Leasehold Improvements, less Accumulated Depreciation		
and Amortization (Note 4)	7,613	4,257
Computer Software Marketing License, net of Amortization (Note 5)	987 [2,365
Other Assets (Note 15 and 16)	2,518	983
Total Assets	\$62,330	\$59,537
Liabilities And Stockholders' Equity		
Current Liabilities:		
Current Portion of Royalties Payable (Note 5)	\$ 4,945	\$ 3,717
Accounts Payable	1,759	723
Deferred Income Taxes (Note 6)	2,020	7,560
Capitalized Lease Obligations (Note 9)	162	206
Other Current Liabilities (Note 8)	2,059	2,764
Total Current Liabilities	10,945	14,970
Royalties Payable (Note 5)	475	675
Capitalized Lease Obligations (Note 9)	186	309
Deferred Income Taxes (Note 6)	6,061	1,740
Total Liabilities	17,667	17,694
	17,007	17,071
Stockholders' Equity:		
Preferred Stock, \$10 Par Value; Authorized 2,500,000 Shares, None Issued	_	
Common Stock, \$.01 Par Value; Authorized 10,000,000 Shares, Issued 5,709,000	C7	50
and 5,800,000 shares respectively (Notes 12 and 13)	57	58
Junior Common Stock, \$.01 Par Value; Authorized 1,000,000 Shares, None Issued	1/ 200	15 700
Additional Paid-In Capital (Notes 12 and 13)	14,209	15,720
Retained Earnings	30,397	26,065
Stockholders' Equity	44,663	41,843
Total Liabilities and Stockholders' Equity	\$62,330	\$59,537

Consolidated Statements of Changes in Financial Position

Software AG Systems, Inc. and Subsidiaries For the Three Years Ended May 31, 1987 (In Thousands)

	1987	1986	1985
Sources of Working Capital:			
Income Before Cumulative Effect of Change in Accounting	\$ 4,332	\$ 8,545	\$ 6,733
Items Which Do Not Use Working Capital:			
Depreciation and Amortization	2,050	1,258	937
Amortization of Marketing License	1,378	1,324	972
Working Capital Provided by Operations Before Cumulative			
Effect of Change in Accounting	7,760	11,127	8,642
Cumulative Effect of Change in Accounting for Recognizing			
Contract Revenue	_		(1,593)
Increase in Noncurrent Deferred Income Taxes	4,321	_	420
Increase in Royalties Payable	www.		140
Increase in Capitalized Lease Obligations	_	_	321
Decrease in Lease Contract Receivable	1,092	378	138
Exercised Stock Options	484	206	155
Shares Issued in Lieu of Vacation	174	_	_
	13,831	11,711	8,223
Uses of Working Capital:			
Acquisition of Common Stock	2,170		4,996
Additions to Property, Equipment and Leasehold			
Improvements, Net of Disposals	5,253	1,564	2,152
Decrease in Noncurrent Deferred Income Taxes	-	980	
Increase in Other Assets	1,688	230	80
Decrease in Royalties Payable	200	180	_
Decrease in Capitalized Lease Obligations	123	166	_
Decrease in Other Liabilities	_	_	47
	9,434	3,120	7,275
Increase in Working Capital	\$ 4,397	\$ 8,591	\$ 948
Summary of Changes in Working Capital:			
Increase (Decrease) in Current Assets:			
Cash and Short Term Investments	\$ (3,143)	\$ 7,101	\$ (3,544)
Accounts Receivable	4,275	4,453	1,528
Current Portion of Lease Contracts Receivable	(430)	(148)	(627
Other Current Assets	(330)	530	69
	372	11,936	(2,574
Increase (Decrease) in Current Liabilities:			
Current Portion of Royalties Payable	1,228	• 909	(2,017
Accounts Payable	1,036	(530)	748
Deferred Income Taxes	(5,540)	2,360	780
Capitalized Lease Obligations	(44)	17	109
Other Current Liabilities	(705)	• 589	(3,142
	(4,025)	3,345	(3,522
	\$ 4,397		

Consolidated Statements of Stockholders' Equity

Software AG Systems, Inc. and Subsidiaries For the Three Years Ended May 31, 1987 (In Thousands)

	Common Stock \$.01 Per Value		Additional	
	Shares	Amount	Paid-In Capital	Retained Earnings
Balance May 31, 1984	6,109	\$61	\$20,351	\$12,380
Shares Acquired and Retired (Note 12)	(349)	(3)	(4,992)	
Exercise of Stock Options (Note 13)	17	_	155	
Net Income			_	5,140
Balance May 31, 1985	5,777	58	15,514	17,520
Exercise of Stock Options (Note 13)	23		206	_
Net Income		_	_	8,545
Balance May 31, 1986	5,800	58	15,720	26,065
Shares Acquired and Retired (Note 12)	(150)	(1)	(2,169)	_
Shares Issued in Lieu of Vacation (Note 12)	12	_	174	
Exercise of Stock Options (Note 13)	47	_	484	
Net Income	_	_		4,332
Balance May 31, 1987	5,709	\$57	\$14,209	\$30,397

Software AG Systems, Inc. and Subsidiaries Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

(a) Principles of Consolidation

The Consolidated Financial Statements include the accounts of Software AG Systems, Inc. and its wholly-owned subsidiaries, Software AG of North America, Inc.; Systems Software I, Inc. (Note 15) and Computer Aided Transcriptions, Inc., a dormant subsidiary (collectively, the Company).

(b) Revenue Recognition

The Company licenses, or leases under arrangements equivalent to a sale, use of its products. The Company's policy is to recognize revenue at the time the product is installed (Note 14). In contracts where there are terms that require the satisfaction of other criteria, such as acceptance upon approval, revenue recognition is delayed until those specific terms are met.

Technical Services fees are recognized as revenue when billed. There are no significant future costs associated with the Company's Technical Service contracts that are not a part of the ongoing conduct of its business; these costs are charged to operations as incurred.

(c) Property, Equipment, and Leasehold Improvements

Property, equipment and leasehold improvements are carried at cost. Certain items of equipment acquired under capital lease agreements have been capitalized and the related lease obligations are classified as liabilities on the consolidated balance sheet.

Property and equipment, including property covered by capital leases, are depreciated on a straight line basis over their respective estimated useful lives. Leasehold improvements are amortized on a straight line basis over their respective lease terms, or estimated useful lives, whichever is less.

(d) Computer Software Costs

Costs incurred internally in creating a computer software product are charged to expense until technical feasibility is established. Technical feasibility is established upon completion of a working model. Thereafter, all production costs are capitalized and reported at lower of unamortized cost or net realizable value. Capitalized costs are amortized based on current and future revenues for the product.

(e) Income Taxes

Deferred income taxes are provided to reflect the tax effect of timing differences between financial and tax reporting.

(f) Income Per Common Share

Income per common share is based on the weighted average number of common shares outstanding and common share equivalents resulting from dilutive stock options. Primary and fully diluted earnings per share are essentially the same.

(g) Reclassifications

Certain reclassifications have been made to 1986 and 1985 financial statement amounts to conform to 1987 financial statement presentation.

2. Cash and Short Term Investments

Included in cash and short term investments at May 31, 1987 and 1986 were short term municipal securities at a cost of \$21,568,000 and \$11,000,000, which approximates market.

Also included in cash and short term investments at May 31, 1986 were U.S. Treasury Notes, at a cost of \$14,803,000, which approximated

Interest from investments for the years ended May 31, 1987, 1986 and 1985 was \$1,655,000, \$2,222,000 and \$2,133,000, respectively.

3. Accounts Receivable and Lease Contracts Receivable

The Company includes in Accounts Receivable amounts due from the licensing of its products and sale of supporting Technical Services. The Company also recognizes revenue upon installation of sales-type leases for the license of its products for periods of up to five years.

At May 31, 1987 and 1986 Accounts Receivable was net of \$2,198,000 and \$1,750,000, respectively, an allowance for specific doubtful accounts.

The receivables from sales-type leases as of May 31 included the following components:

(In Thousands)	1987	1986	
Minimum Lease Payments Receivable	\$8,581	\$10,848	
Less: Unearned Interest Income	2,307	3,052	
Lease Contracts Receivable	6,274	7,796	
Less: Current Portion	3,323	3,753	
Lease Contracts Receivable — Long Term	\$2,951	\$ 4,043	

At May 31, 1987, future minimum amounts receivable from contracts under sales-type leases for each of the next five years are:

(In Thousands)	
Year	Amount
1988	\$4,264
1989	2,225
1990	1,212
1991	754
1992	126
	· \$8,581

Unearned interest income represents the interest factor implicit in the lease payments. Interest income earned on lease contracts receivable for the years ended May 31, 1987, 1986, and 1985 was \$1,254,000, \$1,375,000, and \$1,386,000 respectively.

Fetimated

4. Property, Equipment and Leasehold Improvements

A summary of property, equipment and leasehold improvements at May 31, follows:

(In Thousands)	1987	1986	Life (Years)
Office Furniture, Fixtures and Equipment	\$ 9,872	\$5,341	5-7
Leasehold Improvements	1,934	1,287	2-5
Automobiles	62	62	3-5
Capitalized Equipment Leases	810	900	2-5
	12,678	7,590	
Less: Accumulated Depreciation and Amortization	5,065	3,333	
Net Property, Equipment and Leasehold Improvements	\$ 7,613	\$4,257	

5. Computer Software Marketing License and Royalties

The Company has a perpetual marketing license with its affiliate, Software AG of Darmstadt, West Germany (SAG), for its principal products and all related improvements developed by the Company, SAG or any licensee, in North, Central and South America, Africa, the Middle East, the Far East, Southeast Asia and Australia. The agreement provides that the Company pay SAG royalties ranging from 5% of the standard user's fee for licenses granted in North America to 50% of the fees received for licenses or Technical Services feor users elsewhere. The agreement also provides that SAG will pay the Company royalties ranging from 15% of revenues received by SAG for Technical Services to 25% to 50% of the fees received for products of the Company licenses by SAG. The consideration for the marketing license of \$7,035,000 is being amortized on a basis related to revenues which management estimated would amortize the cost over approximately seven years. The amortization should be completed in fiscal 1988. The unamortized amount at May 31, 1987 and 1986 was \$987,000 and \$2,365,000, respectively.

Amortization expense for the years ended May 31, 1987, 1986, and 1985 was \$1,378,000, \$1,324,000, and \$1,046,000 respectively.

6. Income Taxes

The provisions for taxes on income consisted of the following:

(In Thousands)			
Year Ended May 31,	1987	1986	1985
Federal:			
Current	\$ 3,059	\$ 5,210	\$ 2,900
Deferred	(1,122)	1,180	2,260
	1,937	6,390	5,160
State:			-
Current	472	790	480
Deferred	(97)	200	320
	375	990	800
	\$ 2,312	\$ 7,380	\$ 5,960

The difference between the effective income tax rate and that computed by applying the statutory federal income tax rate is summarized as follows:

Year Ended May 31,	1987	1986	1985
Statutory Federal Income Tax Rate	46.0%	46.0%	46.0%
State Income Taxes (net of federal tax benefit)	3.1	3.4	3.3
Investment Tax Credit	_	(.7)	(.7)
Foreign Tax Credit	(7.9)	(2.0)	(1.7)
Municipal Interest Income Exclusion	(6.0)	(.5)	`
Other	(.4)	.2	.1
Effective Rate	34.8%	46.4%	47.0%

Deferred income tax expense resulting from timing differences between taxable and financial statement income is summarized as follows:

(In Thousands) Year Ended May 31,	1987	1986	1985
Revenue Recognition:			
Cash to Accrual	\$(1,565)	\$1,545	\$2,572
Installment Sales Method	650	_	_
Depreciation and Amortization	(390)	(165)	(11)
Capitalized Software Costs	86	· - ·	_
Other	_	_	19
	\$(1,219)	\$1,380	\$2,580

Effective June 1, 1986, the Company changed, pending IRS approval, from the cash basis of accounting to the accrual basis of accounting for tax reporting purposes. The cash basis timing difference amount that existed at June 1, 1986 is being amortized over a six-year period. In addition, the Company adopted the installment sales method of reporting revenue for tax reporting purposes.

7. Retirement Benefit Plan

The Company has maintained a defined contribution retirement plan for substantially all of its employees since May 31, 1978. On September 14, 1984, the plan was amended to meet the requirements of Section 401(k) of the Internal Revenue Code. On June 10, 1985, the Company received a favorable determination from the Internal Revenue Service. Per the amended plan, at the discretion of the Board of Directors, the Company both matches employee contributions and makes an additional contribution based on the Company's profitability. For the years ended May 31, 1987, 1986 and 1985, the Company contribution was \$145,000, \$677,000 and \$389,000, respectively.

8. Other Current Liabilities and Line of Credit

Other Current Liabilities at May 31 were as follows:

(in Thousands)	1987	1986
Salaries, Wages, Commissions and Related Expenses	\$1,167	\$2,242
Deferred Revenue	682	495
Other	210	27
	\$2,059	\$2,764

During fiscal 1987, the Company extended its Revolving Line of Credit with its principal bank from \$4,000,000 to \$14,000,000. The line may be used for general working capital purposes and as an interim financing for acquisitions. The Company has agreed to a commitment fee of $\frac{3}{6}$ of 1 percent per annum on the unused portion of the commitment. Certain restrictive covenants need to be complied with in order to maintain the availability of the commitment. The Revolving note will bear interest at the bank's prime rate. During fiscal 1987, no amounts were drawn against this line of credit.

9. Lease Obligations and Commitments

The minimum future lease payments for obligations under capital leases at May 31, 1987 are as follows:

(In Thousands)	Year	Amount	
	1988	\$234	
	1989	234	
	1990	25	
Total Minimum Lease Payr	nents	493	
Less: amount representing	interest	145	
Present value of minimum	n lease payments	\$348	

The minimum future rental payments required under operating leases at May 31, 1987 are as follows:

(In Thousands)

Year	Equipment	Facilities	Total
1988	\$334	\$ 3,280	\$ 3,614
1989	10	2,366	2,376
1990	1	1,443	1,444
1991	_	1,436	1,436
1992	_	1,406	1,406
Thereafter		3,829	3,829
	\$345	\$13,760	\$14,105

Not included in future facility rental payments is an estimated \$29,000,000 representing a 12-year lease commitment beginning in fiscal 1989 for the Company's new corporate headquarters (Note 15). The actual amount of these payments will not be known until the construction of the building is complete.

10. Business Segment and International Revenues

The Company is engaged in one industry segment, the development and marketing of systems software, both domestically and worldwide. International marketing is through independent distributors. These revenues are reflected on the Consolidated Statement of Income in both Product and License Fees and Customer Services Fees. Sales to International customers were as follows:

(In Thousands)			
Year Ended May 31,	1987	1986	1985
Geographical Region:			
Far East and Australia	\$ 6,662	\$ 5,704	\$ 5,594
Central and South America	3,483	1,972	1,756
Middle East and Africa	2,339	2,486	2,335
Canada and Europe	2,755	2,297	2,153
_	\$15,239	\$12,460	\$11,838

Included in accounts receivable and lease contracts receivable were amounts due from international customers at May 31, 1987 and 1986 as follows:

(In Thousands)	1987	1986
Far East and Australia	\$3,673	\$2,941
Central and South America	1,272	592
Middle East and Africa	1,954	1,925
Canada and Europe	1,056	966
	\$7,955	\$6,424

11. Supplementary Information

Amounts charged to Other Operating Expenses included the following:

(In Thousands) Year Ended May 31,	1987	1986	1985
Depreciation and Amortization	\$ 2,050	\$ 1,258	\$ 937
Rents for Operating Leases	4,682	3,451	2,762
Advertising and Promotion	3,661	2,596	2,225
Travel and Meetings	4,548	3,232	2,629
Employee Benefits	2,826	2,679	2,152
Other	8,821	7,849	6,552
	\$26,588	\$21,065	\$17,257

12. Common Stock

During fiscal 1985, the Company purchased 342,000 shares of its Common Stock at a cost of \$4,971,000 under a stock repurchase program. In addition, 7,000 shares were acquired from a former employee. All acquired shares were subsequently retired.

During fiscal 1987, the Company purchased 150,000 shares of its Common Stock from a member of its Board of Directors, at a cost of \$2,170,000, which was the fair market value of the stock at the time of the purchase. All acquired shares were subsequently retired. In addition, the Company issued 12,000 shares of stock to employees in lieu of vacation hours accrued.

13. Stock Options — Key Employee Incentive Plan

The Company granted common stock options under the Key Employee Incentive Plan ("1981 Plan"), which authorized the granting of awards to key employees in the form of options to purchase shares of the Company's stock, cash bonuses and awards, and cash or stock performance awards. The Company could grant up to a maximum of 450,000 shares prior to termination of the 1981 Plan during fiscal year 1987. Stock options granted may receive tax treatment as "incentive stock options" ("ISO's") under the Economic Tax Recovery Act of 1981. The option price was the fair market value on the date of grant. Shares were exercisable ratably over a five-year period in sequence of grant.

During fiscal 1987, the Company adopted and granted options under the 1986 Key Employee Incentive Plan ("1986 Plan"), which authorizes the Company to grant up to a maximum of 600,000 shares prior to the termination date on July 22, 1996. The Company may grant awards to key employees in the same form as the 1981 Plan. Subject to certain amendments to the Plan, stock options granted under the 1986 Plan may receive tax treatment as ISO's. The 1986 Plan also authorizes stock options that will not receive ISO tax treatment ("non-qualified stock options"). The option price under the 1986 Plan shall be the fair market value on the grant date and shares may be exercised ratably over a 10-year period.

Both the 1981 Plan and the 1986 Plan provide that a participant may, at the discretion of the Compensation and Organizational Committee of the Board of Directors, either at the time of grant or at the time of exercise of a stock option, receive stock or a cash payment in an amount equal to the difference between the option price and the fair market value at the time of surrender of the shares. Accordingly, payment may be made in cash, in shares, or a combination of both.

The Company has also issued options not part of the 1981 or 1986 Plans to directors and certain officers. Included as outstanding options in the schedule below are 148,910, 159,410, and 89,500 such options at May 31, 1987, 1986 and 1985, respectively.

The following schedule summarizes the changes in stock options outstanding for the three fiscal years ended May 31, 1987.

(In Thousands)	1987	1986	1985
Outstanding, beginning of year	474	308	263
Granted (at an exercise price of \$10.56 in 1987, \$14.06			
to \$18.44 in 1986, and \$13.13 in 1985)	144	215	98
Exercised (at prices of \$7.50 to \$14.06 in 1987 and at			
\$7.50 to \$13.13 in 1986 and at \$7.50 to \$9.31 in 1985)	(47)	(23)	(17)
Expired or cancelled	(52)	(26)	(36)
Outstanding, end of year	519	474	308
Exercisable, end of year	251	200	105
Available for grant, end of year	460	92	207

14. Change in Accounting for Recognizing Contract Revenue

Effective for fiscal 1985, the Company changed its accounting for contract revenue to recognize such revenue when the product is installed as described in Note 1(b). Previously, 90% of the revenue was recognized when the contract was executed, and 10% of the revenue was deferred and reflected in revenues when the product was installed. The Company believes that its adopted accounting is preferable in the circumstances, because it is more conservative and conforms to emerging accounting recommendations.

15. Investment in Real Estate Partnership

During fiscal 1987, the Company, through its subsidiary, Systems Software I, Inc., entered into three (3) real estate partnerships. These partnerships were formed to develop the Company's new corporate headquarters and to ensure expansion options within two office buildings in the same complex. In two of the partnerships, Systems Software I, Inc. serves as a 1% general partner and 34% limited partner. In the third partnership, the subsidiary holds a 25% limited share. Construction on the headquarters building began in May 1987 and is expected to be completed during the first quarter of fiscal 1989. The Company will co-guarantee the completion of the construction of the headquarters building. In addition, the Company has entered into a twelve year lease for the entire building.

The investments in these partnerships are being accounted for under the equity method of accounting. At May 31, 1987, the Company's investment was \$562,000 which is included in Other Assets in the accompanying Consolidated Balance Sheet.

16. Computer Software Costs

During fiscal 1987, the Company capitalize \$178,000 of computer software costs, and amortized \$24,000. At May 31, 1987, the unamortized portion of computer software costs included in Other Assets in the accompanying Consolidated Balance Sheet is \$154,000.

Direct costs for product development during fiscal 1987, 1986 and 1985 were approximately \$2,000,000, \$2,000,000 and \$1,800,000 respectively. These amounts were included in Salaries, Wages and Commissions and in Other Operating Expenses in the accompanying consolidated statements of income.

Report of the Independent Certified Accountants

The Board of Directors Software AG Systems, Inc.

We have examined the consolidated balance sheets of Software AG Systems, Inc. and Subsidiaries as of May 31, 1987 and 1986 and the related consolidated statements of income, stockholders' equity, and changes in financial position for each of the years in the three-year period ended May 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Software AG Systems, Inc. and Subsidiaries at May 31, 1987 and 1986 and the results of their operations and the changes in their financial position for each of the years in the three-year period ended May 31, 1987 in conformity with generally accepted accounting principles consistently applied during the period subsequent to the change, with which we concur, made as of June 1, 1984, in accounting for recognizing contract revenues as described in Note 14 to the consolidated financial statements.

Peat Marwick Main & Co. July 28, 1987 Washington, D.C.

Summary of Quarterly Financial Data (Unaudited)

The following is a summary of selected quarterly financial data for the years ended May 31, 1987 and 1986.

(In Thousands except per share amounts)	***	Quarter Ended		
	Aug. 31, 1986	Nov. 30, 1986	Feb. 28, 1987	May 31, 1987
1987:				
Total Revenues	\$15,397	\$17,087	\$15,274	\$19,486
Net Income	1,103	986	195	2,048
Net Income per Share	.19	.17	.03	.35

(In Thousands except per share amounts)	Quarter Ended			
	Aug. 31, 1985	Nov. 30, 1985	Feb. 28, 1986	May 31, 1986
1986:				
Total Revenues	\$16,036	\$16,354	\$14,642	\$18,727
Net Income	2,880	2,134	1,598	1,933
Net Income per Share	49	.36	.27	.33

Form 10-K

A copy of the Company's Annual Report on Form 10-K for the year ended May 31, 1987, together with financial statements and financial statement schedule as filed with the Securities and Exchange Commission, contains additional information about the Company. A copy of the Company's Annual Report and Form 10-K may be obtained without charge by sending a written request to Gilbert Markbein, Vice President and Controller, Software AG Systems, Inc. 11800 Sunrise Valley Drive, Reston, Virginia 22091.

Phone: (703) 860-5050.

Transfer Agent and Registrar

Manufacturers Hanover Trust Company Box 24935 Church Street Station New York, New York 10249

Stock Price Range and Dividends

On June 19, 1984 the Company began reporting on the National Market System. Stock quotations on the National Market System are on a trade basis. Prior to that date, stock prices were quoted on a bid basis.

The high and low closing prices for the Common Stock for the periods indicated, as reported by NASDAQ, were as follows:

Period	Stock Price	Stock Prices		
,	High Trade	Low Trade		
Year ended May 31, 1986:				
First Quarter .	16¾	11%		
Second Quarter	16¾	121/8		
Third Quarter	20	15¾		
Fourth Quarter	21¾	141/2		
Year ended May 31, 1987				
First Quarter	201/4	164		
Second Quarter	19%	141/2		
Third Quarter	18%	10		
Fourth Quarter	17½	10¼		

The Company has never paid a cash dividend, and it is the present policy of the Company not to do so. The Company believes that the growth and acquisition opportunities in the computer software industry require it to retain its earnings to support future business activity. Payment of future dividends will be dependent upon the earnings and financial condition of the Company and other factors which the Board of Directors may deem appropriate. So long as any amount is outstanding under the Company's Revolving Credit agreement with a commercial bank permitting the borrowing of \$14,000,000, the Company is prohibited from declaring or paying any dividend in cash or assets (other than Common Stock of the Company) which would cause its ratio of debt to tangible net worth to exceed 1 to 1 at the time of such declaration or payment, respectively. The Revolving Credit agreement will terminate on September 30, 1988 at which time the agreement may be extended. No amounts are currently outstanding under the revolving credit agreement.

Stock Information

The common stock of Software AG Systems, Inc. has been traded in the over-the-counter market (NASDAQ Symbol: SAGA) since June 9, 1981. Effective June 19, 1984 the Company's common stock commenced reporting on the NASDAQ National Market System. Prior to June 1981, there was no public market for the Company's common stock.

The 1987 Annual Meeting of Stockholders will be held at 10:30 a.m., local time, on October 22, 1987 at the Madison Hotel, 15th and M Streets, Washington, D.C. 20005.

Directors and Officers

Directors

John Norris Maguire

Chairman of the Board Software AG Systems, Inc.

Stuart J. Miller

President and Chief Executive Officer Software AG Systems, Inc.

**Charles B. Branch

Former Chairman of the Board and Chief Executive Officer Dow Chemical Company

**Robert A. Burgin

Former Chairman of the Board and Chief Executive Officer Leaseway Transportation Corporation

**W.H. Conzen

Former Chairman of the Board and Chief Executive Officer Schering-Plough Corporation

*Peter M. Schnell

President Software AG

Darmstadt, West Germany

Officers

John Norris Maguire

Chairman of the Board

Stuart I. Miller

President and Chief Executive Officer

E. Linwood Pearce

Executive Vice President,

Sales and Marketing

Carlton B. Crenshaw

Vice President and

Chief Financial Officer

Michael E. Jakes

Senior Vice President, International

Michael E. Ater

Senior Vice President

Customer Service Division

Gilbert Markbein

Vice President and Controller

Charles R. Collins

Secretary

Partner

Gibson, Dunn, & Crutcher, Attorneys

^{*}Audit Committee

 $^{{\}bf **} {\bf Compensation} \ and \ {\bf Organizational} \ {\bf Committee}; \ {\bf Audit} \ {\bf Committee}$

Worldwide Sales and Service Offices

Software AG of North America, Inc. 11800 Sunrise Valley Drive Reston, VA 22091 Phone: (703) 860-5050 Telex: 275301 Fax: (703) 648-2584 1-800-843-9534

U.S. Sales Atlanta

6201 Powers Ferry Road, N.W. Suite 250 Atlanta, GA 30339 Phone: (404) 952-5666

Boston

100 Grandview Road Suite 110 Braintree, MA 02184 Phone: (617) 848-5057

Charlotte

9101 Southern Pines Boulevard Suite 200 Charlotte, NC 28217 Phone: (704) 527-7955

Chicago Citicorp Plaza

8420 W. Bryn Mawr Avenue Chicago, IL 60631 Phone: (312) 693-0430

Cleveland

25000 Great Northern Corporate Center Suite 300 North Ulmsted, OH 44070 Phone: (216) 779-3298

5005 L.B.J. Freeway Suite 1250 Dallas, TX 75244 Phone: (214) 991-8900

Denver

300 Union Boulevard Suite 610 Lakewood, CO 80228 Phone: (303) 987-3972

Detroit

39111 W. 6 Mile Road Livonia, MI 48152 Phone: (313) 591-7222

Houston

515 West Greens Road Suite 630 Houston, TX 77067 Phone: (713) 872-0003

Kansas City

8900 Indian Creek Parkway Suite 260 Overland Park, KS 66210 Phone: (913) 451-1651

Los Angeles

18300 Von Karman Avenue Suite 1020 Irvine, CA 92715 Phone: (714) 553-0880

Minneapolis

One Appletree Square Suite 1392 Bloomington, MN 55420 Phone: (612) 854-2298

New Jersey 400 Kelby Street

Fort Lee, NJ 07024 Phone: (201) 461-6611

New York

400 Kelby Street Fort Lee, NJ 07024 Phone: (212) 912-9099

Philadelphia

3 Neshaminy Interplex Suite 301 Trevose,PA 19047 Phone: (215) 245-0122

Pittsburgh

The Landmark Building Suite 1914 1 Station Square Pittsburgh, PA 15219 Phone: (412) 471-4667

Portland

4370 N.E. Halsey St. Suite 233 Portland, OR 97213 Phone: (503) 284-1733

St. Louis

231 South Bemiston Suite 838 Clayton, MO 63105 Phone: (314) 725-0419

San Francisco

101 California St. Suite 3750 San Francisco, CA 94111 Phone: (415) 989-5010

Seattle

10900 N.E. 8th Street Suite 900 W Bellevue, WA 98004 Phone: (206) 451-8055

Washington, D.C.

11490 Commerce Park Drive Reston, VA 22091 Phone: (703) 620-0100

International Sales

Argentina Teleinformatica S.A Avenida Corrientes 345 Buenos Aires, Argentina 1043 Phone: 01-313-1747 Telex: 24816

Australia

SPL (Australia) Pty. Ltd. Level 7, The Gordon Centre 802 Pacific Highway Gordon, NSW 2072 Australia Phone: 02-498-8555 Telex: 26151

Branch offices: Canberra, Melbourne,

Perth, Brisbane

Brazil

Consist Edificio Consist Alameda Jau - 1177 CEP-01420 Sao Paulo SP, Brazil Phone: 011-283-5111 Telex: 1132546

Branch offices: Rio de Janeiro, Brasilia

Canada

Software AG of Canada 151 Savage Drive Cambridge, ONT N1R 5Y2 Canada Phone: 519-622-0889

Branch offices: Calgary, Edmonton, Montreal, Ottawa. Toronto, Winnipeg

Telex: 6959451

Hong Kong SPL Systems (Far East) Ltd. 2106 Shun Tak Centre 200 Connaught Road Central Hong Kong Phone: 5-493828 Telex: 80191

Branch office: Manila, Philippines

SPL System Programming (Israel) Ltd. P.O. Box 7518 Ramat Gan, 52176 Israel Phone: 03-775111

Branch offices: Jerusalem

Telex: 342459

Software AG of Far East Murata Building 2-5. Kanda Surugada Tokyo, Japan 101 Phone: 03-292-2276 Telex: 29349

Branch offices: Osaka, Nagoya

Teleinformatica de Mexico S.A. Arenal No. 40 Col. Chimalistac Mexico 01070 df Mexico Phone: 905-550-4050 Telex: 1761405

New Zealand

System Programming (NZ) Ltd. 7th Floor, Dalmuir House 114 The Terrace Wellington New Zealand Phone: 04-720967 Telex: 30986

Branch office: Auckland

Panama

Software Technology, Inc. P.O. Box 6-8168 El Dorado Republic of Panama Phone: 27-4930 Telex: 3059

Singapore

SPL Systems (S.E.A.) Pte. Ltd. No. 28/11 International Plaza Building 10 Anson Road Singapore 0207 Phone: 225-0607 Telex: 42135

South Africa

Systems Programming (Pty) Ltd. P.O. Box 2822 Randburg 2125 Republic of South Africa Phone: 011-789-2740 Telex: 430682

Branch offices: Cape Town, Durban

Venezuela

A.P.S. C.A. Centro Comercial Bello Campo Local 39 Mezzanina Apartado Postal 61260 Chacao, Caracas Venezuela Phone: 02-329205 Telex: 27433

European Sales

Software AG
Postfach 130123,
Dehmelstrassé 3,
D-6100 Darmstadt-Eberstadt
West Germany
Phone: 06151-5040
Telex: 4197104

Branch offices: Düsseldorf, Hamburg, Munich, Stuttgart

Austria

EDV Software Aktiengesellschaft Mariahilferstrasse 41-43, A-1060 Vienna Austria

Phone: 0222-5875628-0 Telex: 135373

Belgium

Software AG Belgium S.A. Avenue Louise 350, B-1050 Brussels, Belgium Phone: 02-647-6480 Telex; 23339

Denmark

A/S Nordisk Software AG Naverland 3, DK-2600 Glostrup, Denmark Phone: 02-968644 Telex: 33842

Finland

Oy Software AG Finland Läkkisepänkuja 2, SF-02600 Espoo, Finland Phone: 0-513733 Telex: 123951

France

Software AG France S.A.R.L. 7, Rue de Chartres F-92200 Neuilly Sur Seine, France Phone: 01-47476061 Telex: 612447

Branch office: Lvons

Italy

Selesta Sistemi S.P.A. Via Volta 16, 1-20093 Cologno Monzese, Milan Italy Phone: 02-253-8912 Telex: 311354

Branch office: Rome

Middle East

Software Middle East GmbH P.O. Box 59826, Riyadh, Saudi Arabia 11535 Phone: 01-478-6967 Telex: 406483

Netherlands

Software AG Nederland B.V. California Building, Hogehilweg 15 NL-1101 CB Amsterdam Zuidoost Phone: 020-978611 Telex: 10703

Norway

Software AG Norge A/S Chr. Michelsensgate 65, N-0474 Oslo 4, Norway Phone: 02-383660 Telex: 72916

Portugal

Software AG Portugal Campo Grande, 28-3^oC P-1700 Lisboa, Portugal Phone: 01-776477

Spain

Software AG Expaña S.A. Manuel Cortina, 2, E-28010 Madrid, Spain Phone: 01-442-3599 Telex: 48338

Branch offices: Barcelona, Bilbao

Sweden

Software AG Sverige AB Rissneleden 136, S-17248 Sundbyberg, Sweden Phone: 08-733-0030 Telex: 10299

Switzerland

SAG Software Systems AG Neumattstrasse 7, CH-8953 Dietikon Switzerland Phone: 01-7404811 Telex: 828386

Branch office: Lausanne

Turkey

Boss Yazilam Ltd. Macka Cad. No. 27/6 TR-80200 Macka-Istanbul Turkey Phone: 01-1414138 Telex 27395

United Kingdom

Software AG U.K. Limited Laurie House, 22 Colyear Street Derby DEI 1LA, United Kingdom Phone: 0332-372535 Telex: 377995

Branch offices: London, St. Albans

The following are trademarks of Software AG:

ADABAS, ADABAS (VMS), ADABAS 5, ADABAS SQL, CON-NECT, NATURAL, NATURAL Advanced Facilities, NATURAL ELITE, NATURAL GRAPHICS, NATURAL SECURITY, NATURAL 2, NATURAL (VMS), NETWORK, NET-PASS, PREDICT, REVIEW 2, SUPER NATURAL, and SUPER NATURAL 2.

IBM and DB2 are registered trademarks of the International Business Machines Corporation.

DEC, VAX, and VMS are registered trademarks of the Digital Equipment Corporation.

"Performance Today" is a trademark of National Public Radio, Inc.