# ANNUAL REPORT 1998

INTERSHOP

*Creating the Digital Economy*

## FINANCIAL SUMMARY

| In thousands | 1998 € | 1998 DM | 1997 DM | Change in % |
|---|---|---|---|---|
| **RESULTS OF OPERATIONS** | | | | |
| REVENUES | 17,872 | 34,955 | 9,849 | 255% |
| Licenses | 11,295 | 22,092 | 5,764 | 283% |
| Services | 6,250 | 12,224 | 2,975 | 311% |
| Other | 327 | 639 | 1,110 | -42% |
| GROSS MARGIN | 12,365 | 24,183 | 4,593 | 427% |
| RESEARCH AND DEVELOPMENT EXPENSE | 4,368 | 8,543 | 1,968 | 334% |
| SALES AND MARKETING EXPENSE | 18,368 | 35,924 | 9,203 | 290% |
| GENERAL AND ADMINISTRATIVE EXPENSE | 6,729 | 13,161 | 6,755 | 95% |
| OPERATING LOSS | -18,966 | -37,095 | -13,333 | 178% |
| NET LOSS | -17,308 | -33,851 | -13,721 | 147% |
| **ASSETS AND LIABILITIES AS OF DEC. 31** | | | | |
| PROPERTY, EQUIPMENT AND OTHER ASSETS | 4,494 | 8,789 | 4,733 | 86% |
| CURRENT ASSETS | 42,727 | 83,566 | 16,256 | 414% |
| CASH AND CASH EQUIVALENTS | 34,185 | 66,860 | 9,892 | 576% |
| TOTAL ASSETS | 47,220 | 92,355 | 20,989 | 340% |
| SHAREHOLDERS' EQUITY | 34,224 | 66,937 | -9,011 | - |
| LONG-TERM DEBT | 230 | 450 | 3,506 | -87% |
| CURRENT LIABILITIES AND DEFERRED INCOME | 12,766 | 24,968 | 26,494 | -6% |
| **CASH FLOW AND INVESTMENTS** | | | | |
| CASH FLOW FROM OPERATING ACTIVITIES | -20,983 | -41,039 | 4,872 | - |
| INVESTMENT IN EQUIPMENT | -3,302 | -6,459 | -3,720 | 74% |
| **EMPLOYEES AS OF DEC. 31** | | 353 | 179 | 97% |

## CONTENTS

INTERSHOP is creating the **Digital Economy** by supplying the most powerful eCommerce applications for buyers, sellers and intermediaries.

# INTRODUCTION

*Stephan Schambach, President*

*To our Shareholders, Customers and Employees,*

*The year 1998 was very exciting for all of us at INTERSHOP and set the course for our future success. Highlights of 1998 included the initial public offering of INTERSHOP shares on the Frankfurt Stock Exchange, the presentation of new products and continued global expansion. I would like to take this opportunity to express my sincere appreciation to all of those who have contributed to our success. Therefore, it is a pleasure to review some of INTERSHOP's most important achievements of the past year.*

*Revenues were up 255% in 1998. We achieved this on our own strength and with our own products, all of which were designed and engineered in Jena. The 1998 operating results have made INTERSHOP world's fastest growing vendor of eCommerce software.*

*With the introduction of the INTERSHOP 3 platform, we maintained our worldwide technology leadership. INTERSHOP 3 was the solution of choice in virtually every product test by well-known trade publications.*

*As a direct result of our technological leadership and international presence, more than 100 of the world's leading telecommunications companies and Internet service providers are now using INTERSHOP's technology, and more than 10,000 companies are doing business on the Internet with our software. According to a recent report published by Dataquest, INTERSHOP is the world leader in eCommerce with the largest number of live store licenses sold.*

*This achievement is impressive proof of our exclusive focus on the development and marketing of eCommerce software. This focus helped us achieve a gross margin of 69% by year-end 1998, which is considerably above the industry average. It indicates the high potential of INTERSHOP's profitability in the future.*

*How does INTERSHOP intend to keep performing in this fast-moving business over the long term?*

*In addition to our ability to produce and market software successfully, we also have a detailed vision of the future of electronic commerce and its ubiquitous use in the »Digital Economy«.*

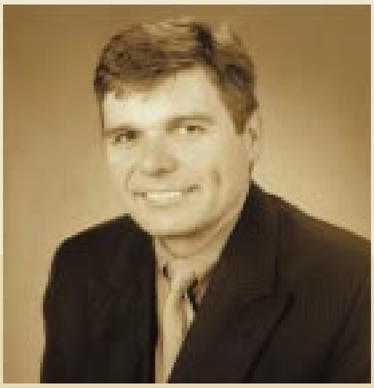
*Over the years, many companies have automated their internal business processes. However, external business transaction, which involve suppliers and their customers, still lack that level of automation and involve communication in writing or over the phone.*

*In the »Digital Economy«, all business partners will be networked, which means they will be able to enter into »digital business relationships«. The Internet – with the help of electronic commerce – will turn this vision into reality. Future possibilities are limitless and will include not only the widespread use of online catalogs, but also intelligent devices that can trigger transactions on their own. In the Digital Economy, refrigerators could automatically order milk, for example, or copiers could order new toner whenever necessary. This vision is made possible by new, more effective technologies like XML and JAVA.*

*We are convinced that the productivity of external business substantially will ultimately match or exceed the level automation already achieved in the area of internal business processes. Imagine a world economy in which the various departments of companies can work just as effectively with external organizations as they do with one another. This will represent a revolution that will result in even greater specialization and more direct communication, which will combine to produce unparalleled savings of time and money in the value-added chain in terms.*

*The market for software for the automation of external business processes is projected to become as large as that for conventional business software. Today, INTERSHOP is poised to lead the coming revolution in e-commerce with software for the »Digital Economy«. In the months and years to come, we will develop technology to allow every company, large or small, to take part in the »Digital Economy«.*

*Stephan Schambach*
*President of INTERSHOP Communications AG*



*Dr. Gert Köhler, Chairman of Supervisory Board*

*The following changes were made to the Management Board:*

*At its meeting of April 23, 1998 the Supervisory Board appointed Mr. Bernd Schlacht, Hamburg, as member of the first Management Board. At the May 26, 1998 meeting Mr. Schacht's appointment was withdrawn and at the same time Mr. Stephan Schambach, California, U.S.A., and Mr. Wilfried Beeck, Hamburg, Germany, were appointed to the first Management Board.*

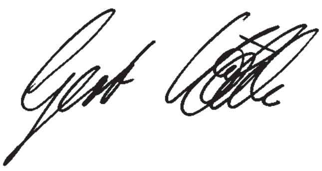
*The Supervisory Board, which did not form any committees, oversaw the functioning of the Management Board regarding the tasks imposed upon it by law and the Articles of Association, and continuously assured itself of the proper conduct of management during the year 1998. Further, the Supervisory Board reported regularly on progress in achieving aims set for the current year and on the prospects for future periods. The Supervisory Board convened for meetings on April 23, 1998, May 26, 1998, June 14 and 22, 1998, September 17, 1998 and December 7, 1998. Discussions at the extraordinary Supervisory Board meeting on April 23, 1998 concerned particularly the incorporation of the enterprise and at the extraordinary meeting on June 22, 1998 the subsequent foundation. Between the meetings of the Supervisory Board urgent decisions were taken by written procedure and these were confirmed in the meetings.*

*The accounts, annual financial statement and management report were audited and given an unqualified auditor's certificate by Arthur Andersen Wirtschaftsprüfungs-gesellschaft Steuerberatungsgesellschaft mbH (auditors and tax consultants), who had been appointed auditors for the stub period of the business year at the share-holders' meeting on July 7, 1998. We agree with the auditing results.*

*The Supervisory Board has checked the annual financial statement to December 31, 1998, the management report as well as the proposed appropriation of earnings. No objections have been raised thereby. The annual financial statements provided by the Management Board was approved today by the Supervisory Board and is thereby finalized.*

*Despite the considerable time expended in transferring the place of registration from San Francisco to Hamburg and the subsequent stock exchange listing, INTERSHOP was also able in the 1998 business year to further develop its market position as one of the world's leading suppliers of eCommerce software. For this achievement the Supervisory Board extends its thanks to the Management Board and the corporation staff.*

*Hamburg, April 28, 1999*



*Dr. Gert Köhler*
*Chairman of Supervisory Board*
*INTERSHOP Communications AG*

# BOARDS

## MANAGEMENT BOARD

**STEPHAN SCHAMBACH**

*President,*
*Strategy and Products*

**WILFRIED BEECK**

*Finance,*
*Sales and Administration*

## SUPERVISORY BOARD

**DR. GERT KÖHLER**
**CHAIRMAN**

*Managing Director*
*Technologieholding VC GmbH*

**THEODORE J. SMITH**

*Chairman FileNet Corp.*

**JÖRG MENNO HARMS**

*Managing Director*
*Hewlett-Packard GmbH*

## MANAGEMENT

In addition to the members of the Management Board of INTERSHOP Communications AG, management includes the highly qualified, experienced senior executives of the INTERSHOP's operational subsidiaries in the U.S.A. and Europe.

**KARSTEN SCHNEIDER**

*Co-founder and*
*Senior Vice President*
*Business Development*

**FRED SELBY**

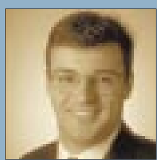
*Senior Vice President*
*Sales & Marketing U.S.A.*

**BERNHARD MARBACH**

*Vice President*
*Sales Europe*

**PETRA VORSTEHER**

*Vice President*
*Strategic Alliances &*
*Business Development*

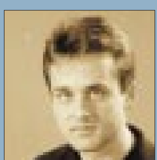


**EDWARD J. CALLAN**

*Vice President*
*Marketing*

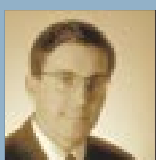
**WOLFGANG SCHOBER**

*Vice President*
*Professional Services*



**FRANK GESSNER**

*Vice President*
*Engineering*



**PHILIP ORESTE**

*Vice President*
*Finance U.S.A.*

**DIRK REICHE**

*Vice President*
*Finance Europe*



*Wilfried Beeck, CFO:*

*»Our shareholders benefit from our corporate strategy, which emphasizes high growth and shareholder value. Through our investor relations activities and an information policy based upon openness and transparency, we intend to build up a long-term relationship of confidence with our shareholders.«*

# Successful Stock Market Debut

The year 1998 marked a major milestone for INTERSHOP Communications AG, which is still a very young company. On July 16, 1998, INTERSHOP appeared on the Neuer Markt of the Frankfurt Stock Exchange, and this initial public offering attracted considerable attention on the part of both the financial community and the media. A total of 2,339,100 of the company's 5,194,967 common shares were placed on the market. At DM 100, the issue price lay at the upper end of the bookbuilding range, which was from DM 80 to DM 100. Following placement of the shares, the public held 45% of the company's share capital. Approximately 80% of the offering was acquired by institutional investors in Germany and abroad. In January and February 1999, another 277,954 shares from the company's conditional capital were approved for trading, and the total number of outstanding shares was 5,472,921 by March 1999. On a fully diluted basis, which means after conversion of options from conditional capital II and III, the number of shares was 6,671,917.

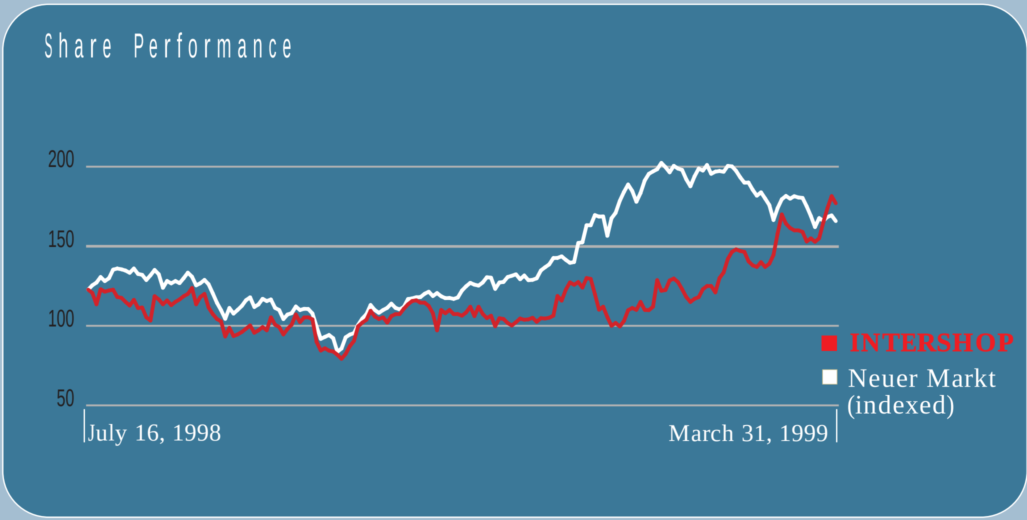
## SHARE PRICE UP DUE TO EXPANSION

As a result of the generally high level of interest in INTERSHOP stock, the price increased 142% to DM 242 on the first day of trading. The stock was able to maintain this level in the weeks thereafter, but the price slackened off slightly in September and October 1998 when the world's stock markets started to feel the effects of a lack of confidence. INTERSHOP shares have been experiencing a definitely positive upward trend since mid-October and reached a historic high of 184 € in late March 1999. At the same time, the average trading volume increased substantially during this period to improve chances of reaching an appropriate price level.

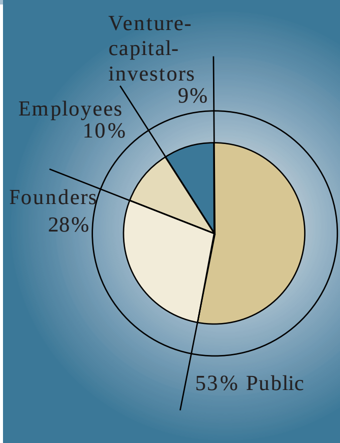
The increase in the share price and the additional liquidity of the shares reflect the company's strategy commitment to expansion and profitability. Investors rewarded the company's performance, which was based upon a strong increase in sales, new products, new strategic alliances and the establishment of new office locations. Intense activity in the area of investor relations also helped reinforce the confidence of shareholders in the company. In addition to regular press releases, a special investor relations department releases timely in-depth information on current business developments in the form of mailings to investors, a regular newsletter and an investor relations Web

### SHARE DATA

| | |
|---|---|
| Securities Identification Number | 622700 |
| Ticker symbol | ISH |
| Stock exchange | Frankfurt Stock Exchange (Neuer Markt) |
| Number of shares as of Dec. 31, 1998 | 5,194,967 |
| Number of shares as of Mar. 31, 1999 | 5,472,921 |
| Number of shares, fully diluted | 6,671,917 |
| Share price as of Mar. 31, 1999 (€) | 177.00 |
| High (floor) as of Mar. 31, 1999 (€) | 184.00 |
| Low (floor) as of Mar. 31, 1999 (€) | 79.25 |
| Fluctuation, 52 weeks | 79.6% |
| 1st day of trading (€) | 123.73 |
| Performance since initial listing | 43.1% |
| Average daily trading volume | 36,808 |
| Market capitalization as of Mar. 31, 1999 (millions of €) | 969 |
| Earnings per share for 1998 (DM) | -6.22 |
| Annual Shareholders' Meeting | June 21, 1999 |




Shareholder Structure
as of March 1999 (fully diluted)




site. A total of eight ad hoc press releases have been issued since the company's appearance on the stock exchange to provide the public with complete up-to-date information on factors affecting the performance of the company's shares. In the context of meetings with individuals and groups of institutional investors and analysts from Germany and abroad, management presented the company's strategy and business developments. These activities helped to increase awareness of and confidence in the company on the capital market. In order to familiarize analysts with eCommerce, which is still a very young market, INTERSHOP Communications held a special eCommerce workshop for financial analysts in January 1999.

### SHAREHOLDER STRUCTURE

All of these activities generated additional demand for INTERSHOP shares on the part of both private and institutional investors. As was expected, institutional investors acquired a majority of the shares previously held by venture-capital investors in March 1999. On a fully diluted basis, 53% of the company's share capital is now held by the public. The company's founders still hold 28% of the share capital, employees 10% and venture-capital investors 9%.

### INTERSHOP NAMED STOCK OF THE YEAR IN 1998

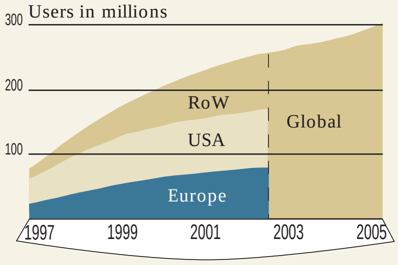
In November 1998, a panel of 40 prominent experts voted INTERSHOP the stock of the year on behalf of TOMORROW, an Internet magazine. The jurors explained their decision by describing INTERSHOP as a pure Internet stock that represents a great hope for the eCommerce industry sector and sets a signal for the future.

*Frost & Sullivan, 1999:*

*»The growth of eCommerce has just started to explode as organizations attempt to make good on the potential of online sales.«*

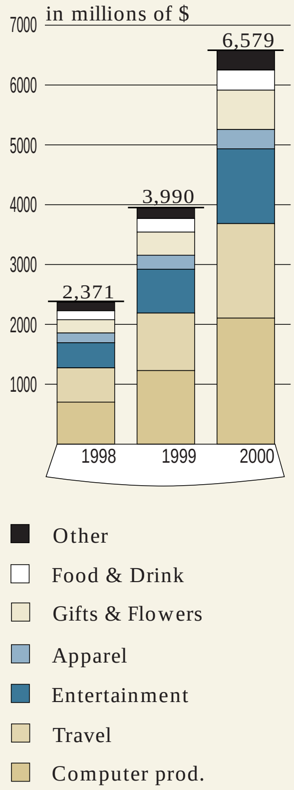
# Explosive Growth

Online population 1997-2005




*Source: Datamonitor*

Projected Online Shopping Revenue by Category, 1998-2000



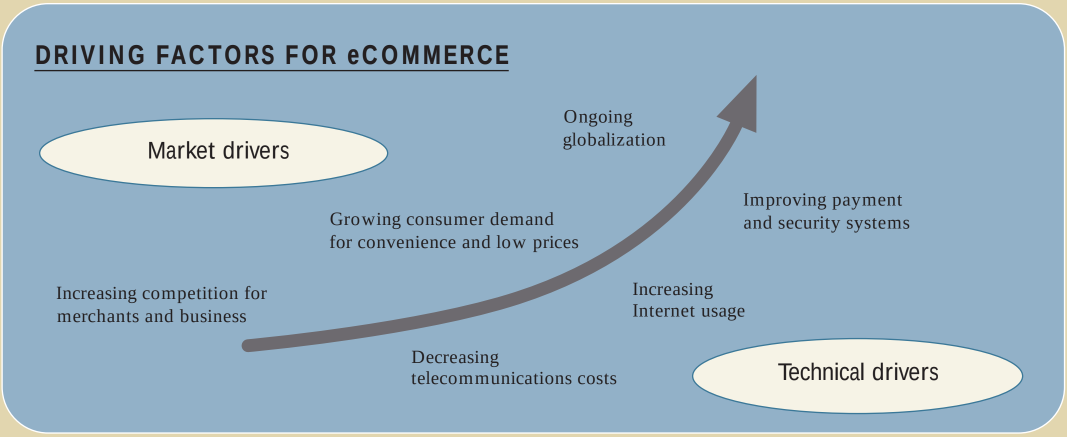

*Source: Forrester Research*

The year 1998 marked a major breakthrough in the development of the Internet. Numerous indicators show that the Internet is rapidly becoming a global medium for both private individuals and businesses. In 1998, the number of Internet users worldwide increased to 148 million (Source: Intelliquest). This increase parallels the explosive increase in information and services on the Internet. Today, approximately 400 million Web sites are live on the Internet, and about 300,000 new ones are added every week. Electronic commerce (eCommerce) and »virtual marketplaces« have lost their novelty appeal and are rapidly becoming an essential prerequisite for success in the marketplace. Manufacturers, suppliers, retailers, service providers and consumers are embracing eCommerce to automate external business processes, eliminate geographical and time barriers and improve their services.

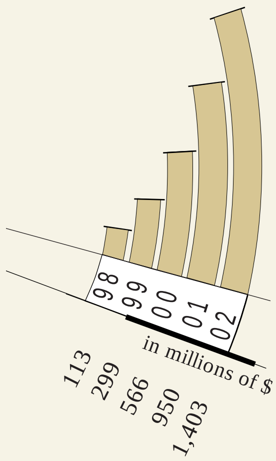
The number of businesses with an Internet presence is increasing exponentially. In the U.S.A., more than 60% of all companies have published Web sites (Source: Giga Information Group). Keenan Vision estimated a total of 17,000 live Internet shops in the U.S. for 1998 and projects an increase to 45,000 for 1999. The volume of business transacted via the Internet in the U.S. reached $43 billion in 1998 and is expected to increase to $1.3 trillion or 9% of total domestic sales by 2003 (Source: Forrester Research). In Western Europe, the world's second largest market, 1998 eCommerce sales were estimated at $5.6 billion (Source: International Data Corp.).

Business-to-consumer transactions accounted for approximately 20% of all Internet business in 1998. The sale of products online is becoming standard in all major industries. The merchandise most commonly sold online today includes books, CDs, travel, and computers, but the Internet is also gradually becoming more popular for the sale of food, clothing and gift articles.

In 1998, online shopping boomed during the Christmas season, and sales tripled over 1997 to reach $3.5 billion (Source: Forrester Research). During this period, 58% of all U.S. Internet households made at least one eCommerce purchase, a fourfold increase over the same period a year earlier.




U.S. Commerce Software Market 1998-2002 Sell-side




Quelle: Forrester Research

The dramatic increase in Internet sales and the broad acceptance of online sales are two driving forces in the market for eCommerce software, one of the most dynamic segments of the software market. Estimated 1998 sales of eCommerce software ranged from $136 million (Frost & Sullivan) to $334 million (Dataquest). Lower sales expense, access to larger and more remote markets, increased customer loyalty and intense competition for the business of retail customers are driving the demand for business-to-consumer eCommerce solutions. In this area, sell-side applications support the sale of products and service to end-users. In the business-to-business segment, buy-side applications link manufacturers and their suppliers. Forrester Research estimated that sell-side applications generated sales of $113 million in the U.S. and expects this figure to soar to $1.4 billion by the year 2002.

The market for sell-side eCommerce applications was affected by two major trends in 1998. On the one hand, there was an increase in demand for affordable high-performance standard applications that can be quickly and easily implemented and upgraded if necessary, especially on the part of small- and medium-sized companies Although businesses with more than 1,000 employees still accounted for over 80% of the total eCommerce market in 1998, small and medium-sized companies with fewer than 1,000 employees will represent the largest segment by the year 2000 (Source: Forrester Research). According to a survey by the U.S. magazine InformationWeek, 83% of all small and medium-sized companies expect eCommerce to play an »important« or »very important« role in their corporate strategies in the near future.

At the same time, demand for eCommerce hosting solutions grew as Internet service providers, telecommunications companies and portals started to offer cost-effective and scalable eCommerce solutions. This business model allows merchants to go online quickly and operate an online store without the need for extensive in-house expertise and a costly IT infrastructure.

*Stephan Schambach, President:*

*»Our technological leadership, and international presence put us in an ideal postion to take maximum advantage of explosive growth in the eCommerce market.«*

# Aiming for Expansion

INTERSHOP Communications is a global leader in the rapidly expanding market for electronic-commerce software, and worldwide leadership in this market is our strategic goal. Numerous well-known market-research companies estimate that sales of eCommerce software will continue to grow exponentially over the next five years. INTERSHOP Communications is in a position to take maximum advantage of this dynamic development.  To strengthen its position of leadership, INTERSHOP Communications has opted for an approach based on long-term investment. Further improvement in the company's prominent market position through the sale of licensed software will take priority over short-term profitability with project business. Over the long term, the company anticipates dynamic expansion accompanied by above-average returns.

## BUSINESS MODEL

INTERSHOP's corporate strategy is based upon the use of a scalable business model. This is the only approach that makes it possible to achieve dynamic expansion based on internal resources and at the same time avoid excessively higher expense. The business model of INTERSHOP Communications is based on the following core elements:

**SOFTWARE LICENSES.** INTERSHOP Communications concentrates on the sale of software licenses because, unlike personnel-intensive services, license products can be produced quickly and in large quantities and also have potentially higher gross margins.

**STANDARD PRODUCTS.** INTERSHOP Communications focuses its resources on the development and marketing of standardized, complete end-to-end eCommerce solutions that meet the needs of the majority of e-retailers. These solutions involve lower per-unit costs and appeal to a broader market than specialized applications.

**PLATFORM-INDEPENDENT TECHNOLOGY.** All INTERSHOP products guarantee maximum independence from third-party technology such as servers, ERP systems and payment systems.

**SELL-SIDE E-COMMERCE.** INTERSHOP 3 technology is intended to meet requirements for sell-side applications, which includes eCommerce solutions for the direct sale of merchandise via the Internet. This segment of the market holds more potential for standardization than buy-side applications, which involve transactions between manufacturers and their suppliers.

**SMALL AND MEDIUM-SIZED COMPANIES.** INTERSHOP Communications chiefly offers eCommerce solutions for small and medium-sized businesses. Over the long term, the potential market is expected to be larger than that represented by large companies because of the sheer numbers involved. With a customer base consisting of a relatively high percentage of medium-sized companies, INTERSHOP Communications can build up a balanced customer structure to reduce dependency on a limited number of large customers.

**INDIRECT SALES.** INTERSHOP Communications currently has more than 600 sales partners worldwide, including Internet service providers, telecommunication companies, system integrators, consulting firms and Web agencies that sell INTERSHOP products and implement them for their customers. This model is important for generating sales and rapid growth.

**REPEAT SALES.** Repeat business from existing customers accounts for a substantial percentage of INTERSHOP's sales since INTERSHOP's well-rounded line of products permits a seamless transition from entry-level systems to high-end solutions.

## COMPETITIVE ADVANTAGES

The products of INTERSHOP Communications are positioned in the market for sell-side eCommerce software and reflect two distinctively different approaches. The INTERSHOP 3 Merchant Edition and the high-end INTERSHOP 3 Enterprise Edition enable companies to build any type of commerce-enabled Web presence, from a single-merchant store to sophisticated enterprise solutions that include the integration of existing legacy systems, based on their own technology infrastructures. The INTERSHOP 3 Hosting Edition and INTERSHOP ePages support hosting applications, which allow Internet service providers, telecommunications companies and Internet communities to set up a large number of shops for rental to online merchants. INTERSHOP Communications competes with other vendors in both segments of the market. Despite intense competition in the markets for self- and outsourced hosting, INTERSHOP Communications has a series of major advantages that reinforce the company's global leadership position. These advantages include:

**LEADING PRODUCT TECHNOLOGY.** Thousands of online shops are now benefiting from the high level of performance offered by INTERSHOP 3 technology, which has earned numerous awards in product tests.

**PRODUCT DEVELOPMENT.** With its central development facility in Jena and more than 150 engineers and technicians there, INTERSHOP Communications has the requisite development capacity for continuous enhancement and expansion of existing products and simultaneous development of the next generation of eCommerce technology.

**PRODUCT LINE.** INTERSHOP products cover all relevant segments of the business-to-consumer market and offer customers a seamless upgrade path.

**WORLDWIDE PRESENCE.** With a total of 14 offices worldwide, INTERSHOP Communications is present in all important major eCommerce markets

**STRATEGIC ALLIANCES.** Technology and marketing agreements with leading manufacturers of hard- and software give INTERSHOP Communications an important means for taking better advantage of existing markets and penetrating new ones.

## MARKET POSITION

INTERSHOP Communications has already staked out a position of leadership in both the segment for self-hosted sell-side eCommerce solutions as well as in the hosting segment. Numerous awards and top rankings in product tests testify to our technological leadership.

INTERSHOP Communications has managed to establish itself among the world's leading providers in terms of sales within a very short period of time. This is confirmed by recent surveys conducted by independent market-research organizations (Dataquest, Frost & Sullivan). In addition, INTERSHOP Communications is now the world leader in terms of the number of stores installed in the Internet. No other provider of eCommerce software can claim anywhere near the same number of live online shops.

*Frank Gessner, Vice President Engineering:*

*»In order to maintain our position of leadership, we have to have the best products available for eCommerce applications. Our software sets benchmarks in terms of versatility, performance and durability. To stay ahead of our competitors, we are already working on tomorrow's products – for the digital economy«.*

# Leading Product Technology

INTERSHOP Communications offers a wide range of products for the implementation and management of complete, scalable end-to-end eCommerce solutions and ranks among the world's leading providers in this market. INTERSHOP Communications develops and markets two different product lines created to meet specific customer needs.

**SELF-HOSTED SOLUTIONS** enable companies of all sizes to install eCommerce solutions quickly and cost-efficiently, and, when necessary, integrate them into existing IT structures and legacy systems.

The **INTERSHOP 3 MERCHANT EDITION** represents the ideal solution for small and medium-sized companies and offers all necessary features, including storefront design, back-office management and a relational database.

The **INTERSHOP 3 ENTERPRISE EDITION** is a powerful high-end solution for large companies and features expanded functionality and maximum performance. Its open system architecture supports development of large-scale business-to-consumer and business-to-business applications and also permits integration with procurement and ERP systems like SAP R/3.

**HOSTING SOLUTIONS** target Internet service providers and telecommunications companies that rent the infrastructure for eCommerce and rent eCommerce shops to small businesses on a monthly basis. This model allows small merchants to go online quickly and inexpensively without investing in IT technology and programming resources.

The **INTERSHOP 3 HOSTING EDITION** is a multi-store solution that gives each individual shop full functionality. The use of several server systems permits efficient load balancing to guarantee optimum performance during peak periods.

The **INTERSHOP ePAGES CARTRIDGE** is the fastest and most economical way to establish an Internet presence with a simple electronic catalog. It also scales to match customer needs as their online business expands.

*»INTERSHOP technology offers globeStores scalable, flexible online shopping solutions and advanced functionality that lets retailers selectively target customers.«*
***Stephen Paternot, President, theglobe.com***

*»INTERSHOP technology offers our customers a package that is as robust as it is modern and flexible – with wizards for storefront design, back-office management and a development language that lets our customers adapt their stores to their business models.«*
***Chris Atkins, Head Product Management, MindSpring***

*»INTERSHOP's simple, easy-to-use technology made it substantially easier for us as a mail-order house to get involved in eCommerce. With our shop system, we offer over 20,000 articles, and we were able to increase sales by over 300% from '97 to '98.«*
***Sven Rost, Head New Media, Westfalia***

*»It took six to eight weeks to go from the original idea to implementation of the entire system, and that exceeded even our most optimistic expectations.«*
***Thomas Meier, Solution Architect, Silicon Graphics***

*»INTERSHOP 3 was our clear choice as the best eCommerce Web site tool.«*
*(Network Computing, December 1998)*

## INTERSHOP 3 AS BASIC TECHNOLOGY

All INTERSHOP products are built on the same award-winning INTERSHOP 3 technology platform, which gives our customers outstanding performance, stability, and a seamless upgrade path to meet their growing eCommerce needs. The openness of the architecture of the current INTERSHOP 3 product generation accommodates the latest Web design technologies and allows customization and integration of legacy and ERP systems. Fast implementation, low cost of ownership and maintenance, high performance and scalability combine to give companies of all sizes a fast return on their electronic-commerce investment.


## THE FEATURES OF INTERSHOP 3 TECHNOLOGY INCLUDE THE FOLLOWING:

Unique multi-media shop design.

Fast implementation.

Low cost of maintenance.

Cartridge concept to facilitate integration into existing legacy systems and IT infrastructures (basic module plus interface module).

Platform-independent.

High performance and scalability through 4-tier architecture and hybrid HTML support.

Maximum data security through multiple-security architecture.

High levels of flexibility.

Integrated database (Sybase, Oracle).

Integrated search engine (Enterprise Edition).

Functions for one-to-one marketing.

Supports all common payment systems.

## PRODUCT DEVELOPMENT

INTERSHOP products are built on state-of-the-art technology and unequalled experience in the development of eCommerce software. They incorporate valuable user feedback collected by customer service and INTERSHOP professional services. A central product management group in San Francisco reviews customer input to determine product specifications. INTERSHOP's presence in the U.S. gives the company access to the world's most advanced eCommerce market, which drives the development of leading-edge technology. INTERSHOP's product development center with more than 150 technical employees is located in Jena, a university town in Eastern Germany that offers an abundant supply of highly qualified software developers. In 1998, INTERSHOP Communications invested DM 8.5 million or 24.4% of the company's total revenues in the development of new products and technology.

New INTERSHOP products are exclusively based upon open software standards and leading-edge technology. In the spring of 1998, INTERSHOP introduced the INTERSHOP 3 application platform consisting of the INTERSHOP 3 Merchant Edition and the INTERSHOP 3 Hosting Edition. The INTERSHOP 3 Enterprise Edition and INTERSHOP ePages then followed in the fall of the year. All INTERSHOP 3 products are available for various hardware platforms and operating systems to give customers a high degree of flexibility and independence. Foreign-language versions of INTERSHOP 3 were developed for Sweden, Spain, and Italy. Various interface cartridges were introduced for third-party payment and transaction systems. To extend the functionality of the standard products, INTERSHOP introduced the INTERSHOP Developer Kit (IDK), a JAVA-based software tool for the creation of flexible interfaces that permits integration of INTERSHOP products into existing systems.

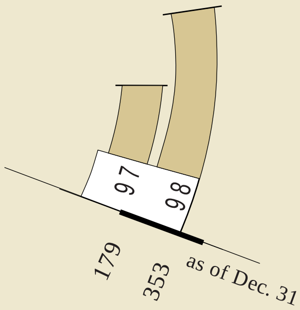
Developement of the next generation of products has a high priority for INTERSHOP Communications. Advanced programming languages will allow the company to continue to set benchmarks in the area of eCommerce. In addition to an array of new functions, new tech-nology will substantially improve communication through the Internet and thereby ultimately create the prerequisites for achieving our vision of the digital economy.

*Simone Baader, Director Human Resources Europe:*

*»What we need more than anything else to succeed in our business is motivated and qualified personnel, and our entire personnel policy is oriented in this direction«.*

# Motivation and Success

Number of Employees




To succeed in its highly competitive market, INTERSHOP builds on the ability of individual to fulfill personal expectations and goals on the job. A talented and motivated workforce with a positive attitude and the determination to outperform our competition is the most important and most valuable asset of INTERSHOP.

## HUMAN RESOURCES

The 1998 business year saw a significant increase in the number of employees at all INTERSHOP locations. The total number of employees worldwide increased from 179 to 353 (29 on a temporary basis) by the end of 1998 to substantially enhance INTERSHOP's capacity for global expansion. With 111 new employees, INTERSHOP Communications GmbH, the sales and marketing arm for all of Europe INTERSHOP's product development division, accounted for the largest increase in our workforce. Substantially strengthening the U.S. market position, the number of INTERSHOP employees in the U.S. grew by 50% to account for a quarter of INTERSHOP's workforce worldwide. At year-end 1998, 47% of all INTERSHOP employees were involved in product and project development and customer service. Sales and marketing accounted for approximately one-third of the company workforce.

## PERSONNEL RECRUITMENT

The strong demand for highly qualified employees in the software industry makes it necessary for INTERSHOP to use various approaches to recruitment. In addition to conventional approaches such as newspaper and magazine advertising, job fairs and direct recruitment at universities and technical schools, INTERSHOP is highly successful in recruiting new people through the Internet. In support of active and passive searches for potential candidates through online employment exchanges, our Web sites represent our most efficient personnel-marketing instrument. The large number of applications generated by Internet job postings indicates how the company's success, corporate culture and cutting-edge technology contribute to the popularity of INTERSHOP Communications as an employer.

## OPEN CORPORATE STRUCTURE

One of our goals for 1998 was to retain the positive aspects of INTERSHOP's corporate culture during the company's aggressive expansion. The corporate culture results from a dynamic approach to all business issues and a high regard for employees' innovative ideas at the departmental level. Freedom for creativity for employees, flat hierarchies, result-oriented compensation for management, open and direct communication and strong commitment to achieving the company's goals through individual satisfaction are other important cornerstones of INTERSHOP's success.

By offering outstanding prospects for personal and professional advancement, INTERSHOP has managed to keep well below the industry average, which we consider one important reason for our success.

## PROFIT-SHARING AS PART OF COMPENSATION

INTERSHOP Communications lets all employees share in the company's success through a stock-option plan. Although common in the U.S., this plan is unique in the industry in Europe and gives the company considerable leverage in the tight market for qualified technical and managerial personnel.

By giving employees the right to acquire stock options, INTERSHOP Communications promotes entrepreneurial thinking, encourages the acceptance of responsibility and fosters loyalty by involving personnel in the financial success of the company. As a result, all INTERSHOP employees share our investors' interest in enhanced shareholder value.

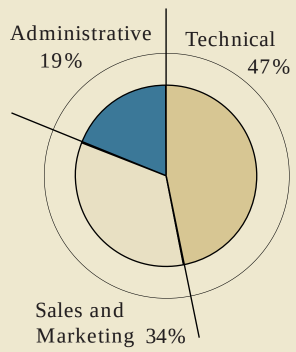
## REGULAR EMPLOYEE MEETINGS

Regular exchange of information and personal contact between employees represents an important element of our corporate philosophy. Management is committed to a policy of sharing information with employees to create a general understanding of corporate objectives and strategies. In addition to the weekly management meetings and the exchange of meeting minutes at the global level, each INTERSHOP location holds weekly company meetings that are attended by all employees. The purpose of these meetings is to give everyone involved an overview of the company's progress.

## CAREER ASSESSMENT

In the second half of 1998, quarterly performance reviews were introduced, to assess the on-the-job performance of INTERSHOP employees help formulate career goals. The individual performance reviews are integral part of our efforts to optimize personnel management throughout the company.

Employees acc. to Activity




# Financial Information

CONTENTS

# REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

We have audited the accompanying consolidated financial statements of INTERSHOP Communications Aktiengesellschaft, Hamburg, as of December 31, 1998. The consolidated financial statements contain according to Sect. 292a HGB and under the provisions of United States generally accepted accounting principles the consolidated balance sheet and the related consolidated statement of operations, shareholders' equity and cash flow and the notes to the consolidated financial statements and are supplemented by the managements' report for the additional information according to Article 36 of the 7th EG-Directive. These financial statements are the responsibility of INTERSHOP Communications AG´s management. Our responsibility is to express an opinion, based on the results of our audits, whether these financial statements are in conformity with United States generally accepted accounting principles and whether the exemption conditions according to Sect. 292a HGB are met.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.  We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of INTERSHOP Communications Aktiengesellschaft as of December 31, 1998 and the results of their operations and their cash flows for the year ended December 31, 1998 in conformity with United States generally accepted accounting principles. The conditions for the exemption from preparing consolidated financial statements according to German accounting principles are met (Sect. 292a Para. 2 HGB).

ARTHUR ANDERSEN
*Wirtschaftsprüfungsgesellschaft*
*Steuerberatungsgesellschaft mbH*

| | |
|---|---|
| *Nendza* | *Schneider* |
| *Wirtschaftsprüfer* | *Wirtschaftsprüfer* |

Hamburg, April 12, 1999

# Group Management´s Report

# and Consolidated Financial Statements

(U.S. GAAP)

INTERSHOP COMMUNICATIONS AG

# GROUP MANAGEMENT'S REPORT FOR THE YEAR ENDED DECEMBER 31, 1998

## ECONOMIC ENVIRONMENT

The economies of the Western industrial countries exhibited generally sluggish growth in 1998, and economies in other regions of the world demonstrated signs of stagnation or recession. Although the U.S. economy continued its course of vigorous expansion, the economies of Western Europe lost considerable momentum during the course of the year. Weak economies in Asia, Latin America, and Russia resulted in an increasing lack of confidence in international financial markets.

Despite regional crises, information technology (IT) remained one of the world's most dynamic growth sectors, because more and more companies are considering IT essential to the implementation of their corporate strategies. For example, worldwide investment in hardware and software was up 19% to approximately DM 920 billion, approximately DM 240 billion of which was accounted for by software solutions.

Demand for standard eCommerce software continued to outpace the overall IT market. The driving forces behind the increase in demand are the clear-cut advantages these products offer companies wanting to market their products and services through the Internet - lower sales costs combined with access to a larger potential market and greater customer loyalty. The considerable increase in the number of Internet users and the sheer volume of sales being transacted online also represent two reasons why companies now selling their products and services through the Internet are expanding their eCommerce activities. At the same time, the demand for standard solutions remains strong. Smaller companies, in particular, are increasingly switching to standard products, which are significantly less expensive to acquire, implement, and support. This trend was especially pronounced in the U.S.A., where eCommerce is rapidly becoming a mass market, whereas electronic marketing is still in the early phases in Europe. The market for hosting solutions, which is served by Internet service providers, telecommunications providers and »portals« that rent individual shops to companies wanting to sell products and services online, continued to exhibit strong growth in 1998. Total 1998 sales of products for eCommerce applications are estimated at $ 227 million as compared with $ 53 million the previous year (Forrester Research). In 1998, the U.S. market remained the most important market by far and accounted for some 70% of all investment in this area. In Europe, the world's second most important market, Germany, the U.K., France, and the Scandinavian countries are the leaders in terms of eCommerce sales. As a result of the difficult economic situation in Asia, anticipated demand in that region failed to live up to expectations. On one hand, more and more eCommerce solutions are appearing on the market. On the other hand, the first signs of a shakeout are becoming evident in this segment of the market.

## COMPANY DEVELOPMENTS

For INTERSHOP Communications, 1998 was a year of continued expansion in all areas. The Company's strategic goal is to establish a position of world leadership in the market for standard software for sell-side eCommerce applications. INTERSHOP Communications intends to achieve this goal through superior technology and intensive marketing activities. Against this background, the Company invested heavily in the development and marketing of its products, as well as in its business and sales organization. In terms of regional priority, the Company focused its activities on the U.S. and Western Europe, the largest and fastest growing markets for eCommerce software.

Investments made during 1998 enabled INTERSHOP Communications to strengthen its position as one of the leading vendors of sell-side eCommerce standard software. According to a survey by International Data Corporation, INTERSHOP software was used more than any other technology for electronic retailing in 1998.

In the area of product development, the launch of INTERSHOP 3 represented the most important event of the year. In early 1998, the INTERSHOP 3 Merchant Edition and the INTERSHOP 3 Hosting Edition were released. The release of the INTERSHOP 3 Enterprise Edition and INTERSHOP ePages Cartridge in the fall rounded out the INTERSHOP spectrum of products at both the upper and lower ends of the eCommerce line, assuring INTERSHOP's presence in all relevant segments of the electronic commerce market. Like its predecessors, the INTERSHOP product line was well received by the marketplace. This was reflected in both heavy demand for the product as well as many awards and favorable ratings in product comparison tests. All products are available on the most important server platforms and can be expanded through a large number of add-ons and interfaces for external transaction and business systems to give customers maximum freedom in terms of their choice of platforms and operational flexibility. In this context, an interface designed in cooperation with KPMG and Hewlett-Packard to integrate INTERSHOP technology with SAP R/3 represented another important milestone this year.

During 1998, INTERSHOP continued to focus on reinforcing its sales and marketing activities. The Company made major additions to its global presence by establishing new locations in the U.S.A., Canada, Australia, and Brazil. At the same time, many new marketing alliances were formed, which included leading international systems integrators, consulting firms, and Web agencies such as KPMG Consulting, CSC Ploenzke, Pixelpark, and Origin. A wide range of marketing activities once again made it possible to increase awareness of INTERSHOP Communications in the company´s core markets.

A core element of the Company's strategy consists of strategic partnerships and alliances with leading manufacturers of hardware and software to penetrate the markets and establish a presence in new segments of the market. Here, too, the Company was able to sign a large number of new agreements covering both technological integration and joint sales and marketing activities intended to enhance the Company's position in the marketplace. For example, cooperative agreements were signed with Oracle, Sun Microsystems, and Silicon Graphics in 1998. In addition, INTERSHOP launched its »Independent Software Vendor« (ISV) program, which proved to be a big success. This worldwide program is based upon the creation of technology partnerships with providers and manufacturers of standard software products that complement one another. Integration with INTERSHOP technology gives our customers an even greater portfolio of additional functionality from which to choose. Shortly after the program was implemented, there are now over 100 ISV partners.

In the course of the year, the Company also invested considerably in its organizational structure. By introducing SAP R/3 as its standard business software and PIVOTAL for customer and order management at all locations, the Company created a scaleable infrastructure that will continue to meet the Company's requirements as it pursues its strategy of expansion. At the same time, the Company recruited experienced management personnel from within the industry, and the number of employees worldwide increased from 179 at the beginning of the year to 353 (including part-time employees) by the end of 1998.

The listing of INTERSHOP Communications on the Neuer Markt in Frankfurt on July 16, 1998, represented a major milestone in the history of INTERSHOP. A total of 2,339,100 shares, 1,000,000 of which stemmed from a capital increase, were placed on the market at DM 100 per share. Net proceeds for the Company came to approximately DM 90 million. The Company was restructured prior to its initial public offering by integrating operating entities into the newly created INTERSHOP Communications AG to obtain the optimum corporate structure for going public.

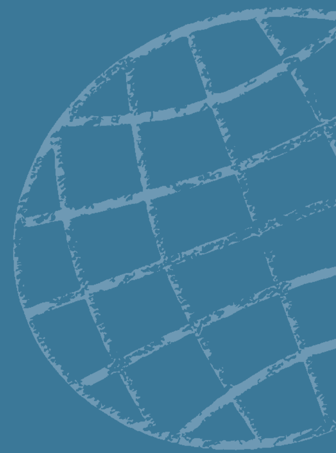
Two new companies were created to reinforce the Company's position in the area of technology. In December 1998, INTERSHOP Software Entwicklungs GmbH was founded in Jena. This Company will primarily focus on research and development of new technologies. INTERSHOP Communications Ventures GmbH was also founded in Hamburg in the same month. This company will be used to develop strategic relationships with other companies through investments in those companies, particularly providers of innovative software technology.

**REVENUES UP 255%**

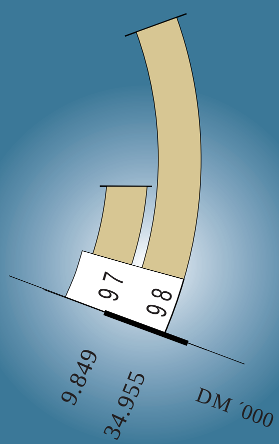
INTERSHOP ended 1998 with worldwide operating revenues of DM 35.0 million, which was DM 25.1 million or 255% higher than the comparable figure of DM 9.8 million a year earlier. This increase resulted primarily from a substantial increase in license revenues, which were up DM 16.3 million or 283% to DM 22.1 million. As a result, license revenues accounted for 63.2% of all revenues as compared with 58.5% in 1997. This increase in license revenues was due to strong demand for standardized eCommerce software, as well as the general expansion of the business activities of the Company. The new INTERSHOP 3 products introduced in the spring and fall of 1998 generated approximately 80% of the increase in license revenues, and the INTERSHOP 3 Hosting Edition and INTERSHOP 3 ePages hosting solutions accounted for the greatest percentage of license revenues. License revenues in the U.S., the world's most competitive market, increased by 369% from DM 1.8 million to DM 8.3 million and clearly outperformed the overall market, which was especially encouraging for INTERSHOP. INTERSHOP Communications also performed well in Europe, where 1998 license revenues were up DM 9.8 million or 246% to DM 13.8 million.

Service revenues, which include income from professional services, customer support and training, were also up a substantial 311% or DM 9.2 million to DM 12.2 million. Although these services do not represent a core business for INTERSHOP Communications, they are of considerable importance in terms of paving the way for license sales. In 1998, Europe accounted for approximately 70% of all service-related revenues.

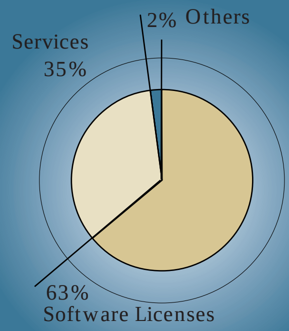
Total U.S. revenues were up DM 9.7 million or 518% to DM 11.6 million, making INTERSHOP Communications one of the leading vendors in the U.S. market. INTERSHOP´s leading position was confirmed in surveys published recently by Frost & Sullivan, Dataquest and International Data Corporation. U.S. revenues accounted for 33.2% of total revenues as compared with 19.1% a year earlier. European revenues amounted to DM 23.3 million, which was DM 15.4 million or 193% higher than the comparable figure for 1997. The latter figures include income from a three-year license and support agreement with Deutsche Telekom in the amount of approximately DM 8 million. In Germany, 1998 total revenues were DM 11.7 million and 66.5% of INTERSHOP's sales were generated abroad.



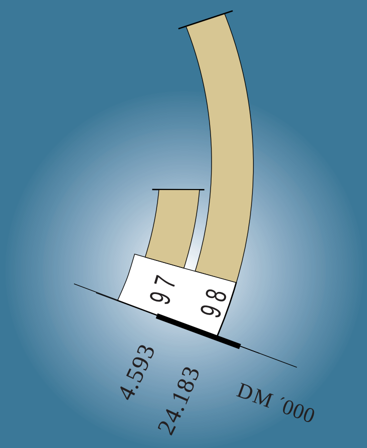
Revenues



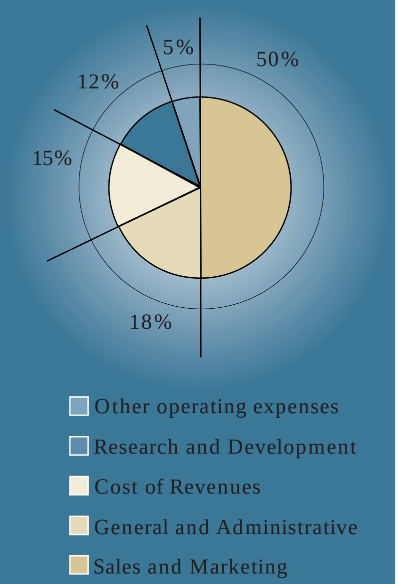

Revenue Structure 1998




Gross Margin




Cost Structure 1998




## GROSS MARGIN CLIMBS TO 69%

Cost of revenues increased DM 5.5 million or 105% to DM 10.8 million, which was markedly lower than the increase in revenues. Gross margin increased from DM 4.6 million to DM 24.2 million, or 426%. Gross Margin from license revenues was up 709% to DM 18.6 million and accounted for 77% of total gross margin. As a result, the gross margin percentage went from 46.6% to 69.2%. In the license area, cost of revenues includes license royalties paid to other companies (especially database providers) as well as the expense of producing and shipping media and manuals. In the service area, the cost of revenues chiefly reflects personnel expenses and a corresponding percentage of operating costs.

## HIGH INVESTMENT IN PRODUCT DEVELOPMENT AND MARKETING

Research and development expense was up DM 6.6 million or 334% to DM 8.5 million, which meant the investment in R&D increased slightly from 20.0% to 24.4% of operating revenues. Product development activities were concentrated in the central development facility in Jena. Development efforts focused on completion and enhancement of the INTERSHOP 3 generation of products introduced in the spring of 1998 and the development of a large number of interfaces with other complementary solutions, primarily payment and business systems. At the same time, intensive work was devoted to the next generation of products.

Marketing and sales expenses were DM 35.9 million as compared with DM 9.2 million in 1997, which represents an increase of DM 26.7 million or 290%. This increase resulted from activities to penetrate new markets, intensify marketing activities of existing locations, and introduce new products. Important activities included the creation of a worldwide sales organization and efforts to increase product awareness in our markets. Marketing activities included advertising campaigns, direct marketing, our presence at trade fairs and the production and distribution of information materials. Almost two-thirds of all marketing and sales expenses were incurred in the U.S., where improvement of our market position is an especially high priority.

General and administrative expenses were up 95% or DM 6.4 million to DM 13.2 million, which was a relatively modest increase. The most important items included here resulted from expansion of our worldwide organization, the creation of new locations, and the introduction of new IT systems. The Company also incurred a nonrecurring charge in the amount of DM 3.65 million in connection with a legal settlement involving rights to the name »INTERSHOP«.

## TURNAROUND IN OPERATING RESULTS

Revenues of DM 35.0 million and operating expenses of DM 72.1 million (including nonrecurring charges in connection with the legal settlement) combined to yield an operating loss of DM 37.1 million in 1998 as compared to a loss of DM 13.3 million in the previous year. These operating results reflect the Company's strategy of major investment in the development of products that offer technological leadership in the early phases of the overall market and the Company itself, in global marketing and in the creation of a worldwide organization in order to benefit as much as possible from expansion of the market over the long term. However, operating results started to exhibit a definitely positive trend in the third half of 1998 since operating revenues outpaced operating costs.

Other income and expense balanced out to DM 3.2 million this year as compared with DM -0.4 million in 1997. This resulted from an increase in interest income to DM 1.9 million and other income in the amount of DM 2.9 million. Other income consists primarily of governmental grants.

The year ended with a net loss of DM 33.9 million, or DM 6.22 per share, compared to a net loss of DM 13.7 million last year, or DM 6.71 per share.

## LIQUIDITY IMPROVES

Current assets increased by DM 67.3 million to DM 83.6 million and accounted for 90.5% of total assets. Cash and cash equivalents went from DM 9.9 million to DM 66.9 million. Trade receivables came to DM 11.5 million as compared with DM 4.4 million the previous year. Working capital was up to 62.0 million from DM (160,000) a year earlier. The company ended the year under review with total assets in the amount of DM 92.4 million as compared with DM 21.0 million in 1997.

Liabilities decreased from DM 30.0 million to DM 25.4 million, mainly due to a decrease in long-term liabilities and deferred revenue. As a result of the increase in capital reserves related to the Company's initial public offering, shareholders' equity rose to DM 66.9 million in 1998 from a deficit of DM 9.0 million a year earlier, and the Company's equity ratio is now 72%.

## CASH FLOW, INVESTMENT, AND FINANCING

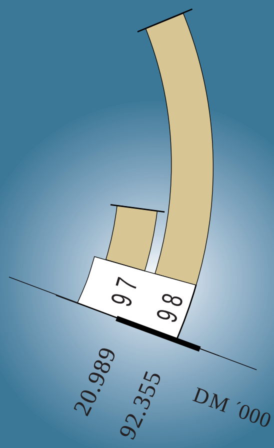
In 1998, the cash flow from operating activities came to DM (41.0) million as compared with a positive balance of DM 4.9 million a year earlier. The two most important reasons for this were the net loss of DM 33.9 million incurred for the year as well as the increase in trade receivables and the decrease in deferred revenue.

In the year under review, cash paid for investing activities were DM 6.5 million as compared with DM 3.7 million for 1997. As in the previous year, hardware and software required for the development of our own products and the creation, operation and expansion of our office organization accounted for most of this item along with the acquisition of miscellaneous office equipment.

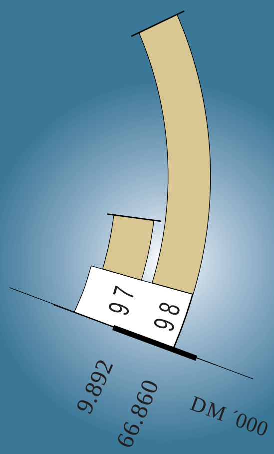
The cash flow from financing activities increased substantially, going from DM 8.0 million to DM 106.6 million in 1998. This increase is primarily attributable to our initial public offering.

Liquid assets increased to DM 66.9 million due to an inflow of funds in the amount of DM 57.0 million.

Total Assets




Cash and Cash Equivalents




## THE CURRENT YEAR

The positive business trend continued into the first quarter of 1999. The number of users of INTERSHOP technology increased substantially and included such well-known companies as Mercedes-Benz and Deutsche Bank. New clients also included leading service providers such as Mindspring and PSINet. In addition, INTERSHOP Communications also entered into important strategic alliances in 1999. A worldwide joint marketing agreement covering eCommerce solutions was signed with Silicon Graphics, a leading vendor of systems for interactive visual computing and high-performance computing. In addition, alliances were formed with Compaq, one of the world´s largest hardware manufacturers, Deutsche Post and TanData Corporation, a leading vendor of software for shipment and logistics systems.

In the context of regional expansion, INTERSHOP Communications AB was founded in Stockholm in March 1999 in order to serve the Scandinavian market for eCommerce applications. In addition, INTERSHOP Communications, Inc. acquired 100% of the assets of Fountainhead Management, Inc., which is located in Melville, New York. This company was mainly acquired to reinforce our workforce in the service area and build up the position of INTERSHOP Communications on the East Coast of the U.S.A., one of the most dynamic e-commerce markets. In the context of streamlining the structure of the group, INTERSHOP Communications S.a.r.l., previously a wholly owned subsidiary of INTERSHOP Communications GmbH, was acquired in March.

## OUTLOOK

Management expects demand for eCommerce software, and especially for high-performance standardized products, to remain strong. These expectations are based upon the conclusions of many market research studies. As a result, INTERSHOP Communications will continue to pursue its corporate strategy of expansion in all areas in 1999. Our overall goal is to strengthen our position in our existing markets and to penetrate new markets. Given the positive projections for the Company's market, management is expecting 1999 sales performance to show substantial improvement over the previous year. At the same time, investment in product development and marketing will be increased once again. The Company is also planning to introduce a new generation of products in 1999. The current year is expected to end with a loss, but management expects operating revenues to increase faster than expenses and is of the opinion that the Company could reach the break-even point in the fourth quarter of 1999.

INTERSHOP COMMUNICATIONS AG

## CONSOLIDATED BALANCE SHEETS AS OF DEC. 31, 1998 AND 1997

*(in thousands DM)*

CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

| Assets | 1998 | 1997 |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | DM 66,860 | DM 9,892 |
| Restricted cash | 223 | 239 |
| Trade receivables, net | 11,512 | 4,437 |
| Prepaid expenses and other current assets | 4,971 | 1,688 |
| Total current assets | **83,566** | **16,256** |
| **PROPERTY AND EQUIPMENT, NET** | 7,172 | 4,089 |
| **OTHER ASSETS** | 1,617 | 644 |
| **TOTAL ASSETS** | DM **92,355** | DM **20,989** |

| Liabilities and Shareholders' Equity | 1998 | 1997 |
|---|---|---|
| **CURRENT LIABILITIES** | | |
| Current debt and current maturities of long-term debt | DM 48 | DM 69 |
| Accounts payable | 5,299 | 4,563 |
| Accrued liabilities | 6,308 | 2,101 |
| Deferred revenue | 9,895 | 9,683 |
| Total current liabilities | **21,550** | **16,416** |
| **LONG-TERM DEBT** | 450 | 3,506 |
| **DEFERRED REVENUE** | 3,418 | 10,078 |
| **TOTAL LIABILITIES** | **25,418** | **30,000** |
| **SHAREHOLDERS' EQUITY** | | |
| Convertible redeemable preferred stock | - | 9,751 |
| Common stock | 25,975 | - |
| Paid-in capital | 98,229 | 915 |
| Notes receivable | (2,793) | (782) |
| Deferred compensation | (1,563) | - |
| Accumulated deficit | (52,839) | (18,558) |
| Cumulative translation adjustment | (72) | (337) |
| Total shareholders' equity | **66,937** | **(9,011)** |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | DM **92,355** | DM **20,989** |

*See accompanying Notes to Consolidated Financial Statements.*

## CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DEC. 31, 1998 AND 1997

*(in thousands DM, except share and per share data)*



| | 1998 | 1997 |
|---|---|---|
| **REVENUES** | | |
| Licences | DM 22,092 | DM 5,764 |
| Services and maintenance | 12,224 | 2,975 |
| Other revenues | 639 | 1,110 |
| Total revenues | **34,955** | **9,849** |
| **OPERATING EXPENSES** | | |
| Cost of revenues | 10,772 | 5,256 |
| Research and development | 8,543 | 1,968 |
| Sales and marketing | 35,924 | 9,203 |
| General and administrative | 13,161 | 6,755 |
| Legal settlement costs | 3,650 | - |
| Total operating expenses | **72,050** | **23,182** |
| **OPERATING INCOME / (LOSS)** | **(37,095)** | **(13,333)** |
| **OTHER INCOME / (EXPENSE)** | | |
| Interest income | 1,892 | 238 |
| Interest expense | (1,559) | (572) |
| Other income (expense) | 2,911 | (54) |
| Total other income (expense) | **3,244** | **(388)** |
| **NET INCOME / (LOSS)** | DM **(33,851)** | DM **(13,721)** |
| **ACCRETION OF REDEEMABLE PREFERRED STOCK** | DM **(430)** | DM **(292)** |
| **NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS** | DM **(34,281)** | DM **(14,013)** |
| **NET LOSS PER SHARE ATTRIBUTABLE TO COMMON SHAREHOLDERS: BASIC AND DILUTED** | DM **(6.22)** | DM **(6.71)** |
| **WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING: BASIC AND DILUTED** | DM **5,507,154** | DM **2,089,000** |

*See accompanying Notes to Consolidated Financial Statements.*

## CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DEC. 31, 1998 AND 1997

*(in thousands DM)*

| | 1998 | 1997 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net loss | DM (33,851) | DM (13,721) |
| *Adjustments to reconcile net loss to cash provided by (used in) operating activities :* | | |
| Depreciation | 3,249 | 998 |
| Provision for doubtful accounts | 526 | 131 |
| Amortization of deferred compensation | 317 | - |
| Legal settlement costs | 3,650 | - |
| Gain on equipment disposal | (7) | - |
| *Change in:* | | |
| Restricted cash | - | (229) |
| Accounts receivable | (7,980) | (4,388) |
| Prepaid expenses and deposits | (3,316) | (1,607) |
| Other assets | (114) | (76) |
| Accounts payable | 853 | 3,677 |
| Deferred revenue | (6,348) | 19,204 |
| Accrued expenses and other liabilities | 1,982 | 883 |
| Net cash provided by (used in) operating activities | **(41,039)** | **4,872** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchase of other assets | (1,001) | - |
| Purchases of equipment, net of capital leases | (6,459) | (3,720) |
| Net cash used in investing activities | **(7,460)** | **(3,720)** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Proceeds from sale of preferred stock | 3,555 | 6,605 |
| Proceeds from sale of common stock, net | 105,545 | - |
| Proceeds from debt issuance | 3,863 | 3,452 |
| Repayments of indebtedness | (6,324) | (2,008) |
| Net cash provided by financing activities | **106,639** | **8,049** |
| **EFFECT OF CHANGE IN EXCHANGE RATES ON CASH** | **(1,172)** | **273** |
| **NET CHANGE IN CASH AND CASH EQUIVALENTS** | 56,968 | 9,474 |
| **CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD** | 9,892 | 418 |
| **CASH AND CASH EQUIVALENTS, END OF PERIOD** | DM **66,860** | DM **9,892** |

*See accompanying Notes to Consolidated Financial Statements.*

INTERSHOP COMMUNICATIONS AG

# CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT) AND COMPREHENSIVE INCOME (LOSS) FOR THE YEARS ENDED DEC. 31, 1998 AND 1997

*(in thousands DM, except share and per share data)*

| | Convertible Redeemable Preferred Stock Shares | Convertible Redeemable Preferred Stock Amount | Common Stock Shares | Common Stock Stated Value | Additional Paid-In Capital |
|---|---|---|---|---|---|
| Balance, December 31, 1996 | 2,240,000 | DM 2,650 | 2,000,000 | DM - | DM 100 |
| *Comprehensive income:* | | | | | |
| Net loss | - | - | - | - | - |
| Foreign currency translation adjustments | - | - | - | - | - |
| *Comprehensive income* | - | - | - | - | - |
| Issuance of common stock | - | - | 7,500 | - | 33 |
| Exercise of stock options | - | - | 201,770 | - | 782 |
| Issuance of Series C preferred stock | 400,000 | 6,809 | - | - | - |
| Accretion of preferred stock | - | 292 | - | - | - |
| Balance, December 31, 1997 | **2,640,000** | **9,751** | **2,209,270** | - | **915** |
| *Comprehensive income:* | | | | | |
| Net loss | - | - | - | - | - |
| Foreign currency translation adjustments | - | - | - | - | - |
| *Comprehensive income* | - | - | - | - | - |
| Issuance of common stock of Inc. | - | - | 20,000 | - | 364 |
| Issuance of Series D preferred stock | 77,970 | 3,663 | - | - | - |
| Issuance of common stock for cash and forgiveness of legal settlement obligation | - | - | 76,697 | 383 | 12,237 |
| Accretion of preferred stock | - | 430 | - | - | - |
| Shares not converted | (195,200) | - | (882,000) | - | - |
| Conversion of preferred stock of subsidiary to common stock of parent, net of share amounts not converted | (2,522,770) | (13,844) | 2,522,770 | - | 13,844 |
| Reclassification for formation of AG | - | - | - | 19,351 | (19,351) |
| Issuance of common stock in IPO, net | - | - | 1,000,000 | 5,000 | 87,570 |
| Exercise of stock options | - | - | 248,230 | 1,241 | 770 |
| Deferred compensation | - | - | - | - | 1,880 |
| Amortization of deferred compensation | - | - | - | - | - |
| Balance, December 31, 1998 | - | DM - | **5,194,967** | DM **25,975** | DM **98,229** |

*See accompanying Notes to Consolidated Financial Statements.*

| | Notes Receivable | Deferred Compensation | Accumulated Deficit | Foreign Currency Translation Adjustment | Total Stockholders' Equity (Deficit) | Comprehensive Income (Loss) |
|---|---|---|---|---|---|---|
| | DM- | DM- | DM (4,545) | DM (79) | DM (1,874) | DM- |
| | | | | | | |
| | - | - | (13,721) | - | (13,721) | (13,721) |
| | - | - | - | (258) | (258) | (258) |
| | **-** | **-** | **-** | **-** | **-** | **(13,979)** |
| | - | - | - | - | 33 | - |
| | (782) | - | - | - | - | - |
| | - | - | - | - | 6,809 | - |
| | - | - | (292) | - | - | - |
| | **(782)** | **-** | **(18,558)** | **(337)** | **(9,011)** | **-** |
| | | | | | | |
| | - | - | (33,851) | - | (33,851) | (33,851) |
| | - | - | - | 265 | 265 | 265 |
| | **-** | **-** | **-** | **-** | **-** | **(33,586)** |
| | - | - | - | - | 364 | - |
| | - | - | - | - | 3,663 | - |
| | - | - | - | - | 12,620 | - |
| | - | - | (430) | - | - | - |
| | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| | - | - | - | - | 92,570 | - |
| | (2,011) | - | - | - | - | - |
| | - | (1,880) | - | - | - | - |
| | - | 317 | - | - | 317 | - |
| | DM **(2,793)** | DM **(1,563)** | DM **(52,839)** | DM **(72)** | DM **66,937** | DM- |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. ORGANIZATION AND OPERATIONS OF THE COMPANY

INTERSHOP Communications AG (the »Company«) was originally founded in 1992 as NetConsult Communications GmbH (»GmbH«) in Germany as a limited liability company. GmbH established a wholly owned subsidiary, NetConsult Communications, Inc. (»U.S. Inc.,«), a Delaware corporation, in March 1996. On December 31, 1996, U.S. Inc., GmbH, and the shareholders of GmbH entered into a Share Exchange Agreement, whereby U.S. Inc. acquired all outstanding interest in GmbH in exchange for preferred and common stock in U.S. Inc. As a result, GmbH became a wholly owned subsidiary of U.S. Inc. and certain debt in NetConsult GmbH was converted into preferred stock in U.S. Inc. With the completion of this share exchange, the parent entity converted from being a limited liability company to a corporation. In December 1996, the Company changed its name to INTERSHOP Communications, Inc. In June 1998, 79.26% of the shareholders of U.S. Inc. exchanged their preferred and common stock of U.S. Inc. into 4,118,270 shares of the Company's common stock. As a result of this exchange, U.S. Inc. became a majority-owned subsidiary of INTERSHOP Communications AG, a German corporation.

Unless otherwise noted, all references to the »Company« refer to INTERSHOP Communications AG and its predecessors.

The Company develops and distributes applications software offering on-line shopping solutions which enable merchants, businesses, Internet service providers and others to create and host fully interactive business-to-business or business-to-consumer eCommerce storefronts, supply-chain management systems and shopping centers (virtual malls) over the Internet, Intranet, or Extranet.

The Company is subject to a number of risks, including, but not limited to, operating in a new and rapidly evolving market, competition from larger companies, dependence on new products, dependence on key personnel, uncertain profitability, and a limited operating history.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### *Basis of Financial Statements*

The consolidated financial statements, which have been prepared according to United States generally accepted accounting principles (»U.S. GAAP«), include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances between the companies have been eliminated. As discussed in Note 1, two shareholders representing 20.74% of the outstanding common stock of U.S. Inc. did not convert their shares to shares of the Company. The book value of these shares is DM 296,110 and is included in the consolidated equity of the Company.

## Use of Estimates

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

## Foreign Currency Translation

The functional currency of the Company's operations outside Germany is the local country's currency. Consequently, assets and liabilities of operations outside Germany are translated into German Marks using exchange rates at the end of each reporting period. Revenues and expenses are translated at the average exchange rates prevailing during the period. Cumulative translation gains and losses are reported as a separate component of shareholders' equity.

As discussed above, the Company is a German corporation whose reporting currency is the German Mark. In prior years, the reporting currency of the Company was the United States Dollar. Prior year amounts have been restated to present the reporting currency of the Company in German Marks.

## Statement of Cash Flows

The Company paid DM 1,057,000 and DM 447,000 in cash for interest in 1998 and 1997, respectively. The Company paid DM 26,000 and DM 17,000 in cash for taxes in 1998 and 1997, respectively. The Company sold equipment and leased it back in 1997. The Company recognized no gain or loss on the transactions and the value of the leased equipment is DM 233,000. In 1996, the Company converted debt of DM 2,650,000 into 2,240,000 shares of preferred stock in U.S. Inc. in conjunction with the Share Exchange Agreement discussed in Note 1.

The Company considers all investments with original maturities of 90 days or less to be cash equivalents.

## Concentration of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of accounts receivable. The Company performs ongoing credit evaluations of its customer's financial condition and the risk with respect to trade receivables is further mitigated by the fact that the Company's customer base is diversified.

## Property and Equipment

Property and equipment are stated at cost. Capital leases are recorded at the present value of the future minimum lease payments at the date of acquisition. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three years. Capital leases and leasehold improvements are amortized on a straight-line basis over the shorter of the lease terms or their estimated useful life.

## Software Development Costs

Capitalization of software development costs begins upon the establishment of technological feasibility of the product, which the Company defines as the development of a working model and further defines as the development of a beta version of the software. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs requires considerable judgement by management with respect to certain external factors, including, but not limited to, anticipated future gross product revenue, estimated economic life and changes in technology. Such costs are reported at the lower of unamortized cost or net realizable value. To date, internal software development costs that were eligible for capitalization have not been significant and the Company has charged all software development costs to research and development as incurred.

The Company expenses all research and development expenses as incurred.

## Revenue Recognition

The Company generates the following types of revenue:

License fees. License fees are earned under software license agreements to end-users, resellers, and distributors. Revenues from licenses to end-users are recognized upon shipment of the software if collection of the resulting receivable is probable, the fee is fixed and determinable, and there are no significant post-delivery obligations. If an acceptance period is required, revenues are recognized upon the earlier of customer acceptance or the expiration of the acceptance period. Certain of the Company's sales are made to distributors under agreements allowing certain rights of return and price protection on unsold merchandise. Accordingly, the Company either defers recognition of such sales until the merchandise is sold by the distributor, or records a reserve for returns if the amount of returns is limited by the contractual terms.

Service fees. Services consist of support arrangements and consulting and education services. Support agreements generally call for the Company to provide technical support and provide certain rights to software updates to customers. Revenue on technical support and software update rights is recognized ratably over the term of the support agreement. The Company provides consulting and education services to its customers; revenue from such services is generally recognized as the services are performed.

In June 1997, the Company entered into a software license agreement with a customer for total license fees of DM 19.8 million, which was received in cash in 1997. The Company is recognizing the revenue associated with this agreement over the three-year term of the agreement. In 1997, the Company recognized DM 3.3 million of revenue associated with this agreement, representing 33% of consolidated revenue in 1997. In 1998, the Company recognized DM 6.7 million of revenue associated with this agreement, and DM 1.5 million related to other agreements with this customer, which combined represent 23% of consolidated revenue in 1998. During 1997, this customer acquired 400,000 shares of preferred stock at approximately DM 17 per share. Management believes that this price represented the fair value of the preferred stock.

Sales to another customer represented 13% of consolidated revenue in 1997.

## Accounting for Stock-Based Compensation

Effective January 1, 1996, the Company adopted the disclosure provisions of SFAS No. 123, »Accounting for Stock-Based Compensation.« In accordance with the provisions of SFAS No. 123, the Company applies Accounting Principles Board (»APB«) Opinion No. 25 and related interpretations in accounting for its employee stock option plans.

## Income Taxes

Deferred income taxes are provided for timing differences in recognizing certain income, expense, and credit items for financial reporting purposes. Such deferred income taxes primarily relate to operating loss carryforwards, tax credits, timing of recognition of certain revenue items, and the timing of the deductibility of certain reserves and accruals for income tax purposes.

## Earnings Per Share

Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common and common equivalent shares outstanding during the period. Common equivalent shares consist of stock options and warrants (using the treasury stock method). Common equivalent shares are excluded from the dilutive computation only if their effect is anti-dilutive. As the Company recorded a net loss in each of two years in the period ended December 31, 1998, no common equivalent shares are included in diluted weighted-average common shares outstanding.

## 3. PROPERTY AND EQUIPMENT

Property and equipment consists of the following (in thousands):

| | 1997 | Additions | Disposals | 1998 |
|---|---|---|---|---|
| Computer equipment | DM 4,064 | 5,496 | (106) | DM 9,454 |
| Furniture and fixtures | 1,311 | 963 | (48) | 2,226 |
| Leasehold improvements | 71 | - | - | 71 |
| | 5,446 | 6,459 | (154) | 11,751 |
| Accumulated depreciation and amortization | (1,357) | (3,249) | 27 | (4,579) |
| Property and equipment, net | DM **4,089** | | | DM **7,172** |

Leased equipment under capital leases included in property and equipment as of December 31, 1998 and 1997 was DM 223,000. Accumulated amortization of leased equipment was DM 50,000 and DM 12,000 as of December 31, 1998 and 1997, respectively.

As of December 31, 1998, future minimum lease payments under capital leases together with their present value were *(in thousands)*:

| | | |
|---|---|---|
| Year Ending December 31, | | |
| 1999 | DM | 90 |
| 2000 | | 81 |
| Total minimum lease payments | | 171 |
| Amounts representing interest | | (23) |
| Present value of minimum lease payments | | 148 |
| Less current portion | | (48) |
| | DM | **100** |

## 4. COMMITMENTS

Facilities and certain furniture and equipment are leased under operating leases. As of December 31, 1998, future minimum annual lease payments (excluding the lease payments relating to capitalized facilities discussed in Note 3) are as follows *(in thousands)*:

| | | |
|---|---|---|
| Year Ending December 31, | | |
| 1999 | DM | 2,185 |
| 2000 | | 2,178 |
| 2001 | | 2,200 |
| 2002 | | 1,821 |
| 2003 | | 1,061 |
| Total | DM | **9,445** |

Rent expense was DM 2,497,000 and DM 963,000 for the years ended December 31, 1998 and 1997, respectively.

## 5. LONG-TERM DEBT

The components of long-term debt as of December 31, 1998 and 1997 are *(in thousands)*:

| | | 1998 | | 1997 |
|---|---|---|---|---|
| TBG loans | DM | 0 | DM | 3,000 |
| Loans from shareholders | | 350 | | 350 |
| Capital leases (Note 3) | | 148 | | 225 |
| Total | | **498** | | **3,575** |
| Current maturities | | (48) | | (69) |
| Long-term debt | DM | **450** | DM | **3,506** |

TBG loans: During 1996, the Company entered into a series of unsecured loans with Technologie-Beteiligungs-Gesellschaft mbH der Deutschen Ausgleichsbank (»TBG«). Interest is payable twice yearly at 6%. In addition, TBG was entitled to a royalty of 6% of net income on an annual basis while the loans were outstanding. This amount is payable within two weeks of the end of each year. As the Company has recorded net losses in 1997 and 1996, no royalty amounts have been payable to TBG for either of those years. All principal and unpaid interest is due and payable on December 31, 2006. In the event that the loan is repaid within five years of the issue date, TBG is entitled to a 30% premium on the principal amount outstanding. The Company had recognized the premium as additional interest expense on a straight-line basis over five years. Subsequent to the Company's initial public offering, the Company repaid the full principal amount of the TBG loans in addition to a premium of DM 900,000. The previously unrecognized premium has been classified as interest expense in the accompanying statement of operations.

Loans from shareholders: During 1996, the Company entered into a series of unsecured loans with certain shareholders. Interest is payable quarterly at 10%. The loans may be repaid at any time, but no later than February 2004. Cumulated interest of DM 99,000 was not paid until December 31.

## 6. SHAREHOLDERS' EQUITY

### Reverse stock split

In conjunction with the share exchange between the shareholders of U.S. Inc. and the Company in June 1998, the Company effected a 1-for-5 reverse stock split. All share and per share amounts have been restated to retroactively reflect this reverse stock split.

### Convertible Redeemable Preferred Stock

In December 1996, the Company converted debt of DM 2,650,000 into 2,240,000 shares of preferred stock in U.S. Inc. in conjunction with the Share Exchange Agreement discussed in Note 1. In December 1997, the Company sold 400,000 shares of preferred stock at approximately DM 17 per share resulting in aggregate proceeds of DM 6.8 million. In March 1998, the Company sold 77,970 shares of preferred stock in U.S. Inc. at approximately DM 47 per share resulting in aggregate proceeds of DM 3.7 million.

Significant rights, restrictions, and preferences of preferred stock included cash dividends at a rate of 8% per annum, as defined, liquidation preferences, voting rights, and conversion and redemption features.

In conjunction with the share exchange between the shareholders of U.S. Inc. and the Company in June 1998, all outstanding shares of preferred stock converted to the same number of shares of common stock.

## *Deferred compensation*

In connection with the grant of certain stock options to employees during the year ended December 31, 1998, the Company recorded deferred compensation of approximately DM 1.9 million representing the difference between the deemed value of the common stock for accounting purposes and the option exercise price of such options at the date of grant. This amount is presented as a reduction of shareholders' equity and amortized ratably over the vesting period of the applicable options. Approximately DM 317,000 was expensed during the year ended December 31, 1998, and the balance will be expensed ratably over the period the options vest. Compensation expense is decreased in the period of forfeiture for any accrued but unvested compensation arising from the early termination of an option holder's services. No compensation expense related to any other periods presented has been recorded.

## *1997 Equity Incentive Plan*

The Company had originally reserved 2,000,000 shares of common stock for issuance to employees, directors and consultants under its 1997 Equity Incentive Plan (the »Plan«). The Board of Directors may grant incentive or non-statutory stock options at prices not less than 100% or 85%, respectively, of fair market value as determined by the Board of Directors, at the date of grant. Options vest ratably over periods determined by the Board, generally three years. The Board also has the authority to set exercise dates (no longer than ten years from the date of grant), payment terms, and other provisions for each grant. The Company generally has the right of first refusal for all common stock issued under the Plan should the holder desire to sell or otherwise transfer any of the shares. The Company's right of first refusal terminated upon the effective date of the Company's initial public offering.

## *Stock-Based Compensation*

The company applies APB Opinion No. 25 and related interpretations in accounting for the Plan. If compensation cost for the Plan had been determined based on the minimum value at the grant dates for the awards calculated in accordance with the method prescribed by SFAS No. 123, the impact on the Company's net loss and net loss per share would have been reduced to the following amounts *(in thousands, except per share amounts)*:

| | 1998 | 1997 |
|---|---|---|
| **NET LOSS** | | |
| As reported | DM(33,851) | DM (13,721) |
| Pro forma | DM(34,349) | DM (34,349) |
| **BASIC AND DILUTED EPS** | | |
| As reported | DM (6.22) | DM (6.71) |
| Pro forma | DM (6.32) | DM (6.73) |

Option activity under the Plan was as follows *(in thousands, except per share data)*:

| | 1997 | | 1998 | |
|---|---|---|---|---|
| | Number of Shares Outstanding | Weighted Average Exercise Price | Number of Shares Outstanding | Weighted Average Exercise Price |
| Outstanding at beginning of year | 0 | DM 0 | 433 | DM 3.37 |
| Granted | 702 | 3.81 | 264 | 24.70 |
| Exercised | (202) | 3.83 | (248) | 6.72 |
| Canceled | (67) | 6.59 | (74) | 5.92 |
| Outstanding at end of year | **433** | DM **3.37** | **375** | DM **17.20** |

As of December 31, 1998, options to purchase 209,064 shares at exercise prices between DM 0.08 and DM 36.00 were vested.

The Plan allows for the issuance of options that are immediately exercisable through execution of a restricted stock purchase agreement. Shares purchased subject to a restricted stock purchase agreement generally vest over three years. In the event of termination of employment, the Company may repurchase unvested shares at a price equal to the original issuance price. As of December 31, 1998, 255,646 shares of common stock issued and outstanding were unvested and subject to repurchase by the Company at DM 0.08 to DM 7.12 per share. All shares that were exercised early are held by a trustee on behalf of the employee. In the event that an employee leaves the Company with unvested shares, the unvested shares are sold in the open market, and the proceeds of the sale are contributed to the Company.

The fair value of each option grant is estimated on the date of grant utilizing risk-free interest rates on the date of grant with maturities equal to the expected option term (5.8%-6.5% in 1997 and 4.2%-5.6% in 1998) and a term of 4.5 years.

## Conditional Capital

As of December 31, 1998, the Company has up to 1,977,200 shares of conditional capital for future issuance as follows:

| | |
|---|---|
| Conversion of remaining U.S. Inc. shares | 1,077,200 |
| Stock options | 900,000 |
| | **1.977,200** |

## 8. INCOME TAXES

The Company accounts for income taxes using an asset and liability approach under which deferred income taxes are provided based upon enacted tax laws and rates applicable to the periods in which taxes become payable.

The components of the deferred tax asset were as follows *(in thousands)*:

| | 1998 | 1997 |
|---|---|---|
| Net operating loss carryforwards | DM 19,161 | DM 4,486 |
| Tax credit carryforwards | 82 | 40 |
| Accruals not currently deductible | 989 | 167 |
| Capitalized start-up costs | 34 | 9 |
| Other | 84 | 60 |
| | **20,350** | **4,762** |
| Valuation allowance | (20,350) | (4,762) |
| Net deferred tax asset | DM - | DM - |

A valuation allowance has been recorded for the entire deferred tax asset as a result of uncertainties regarding the realization of the asset including the limited operating history of the Company and the lack of profitability to date and the variability of operating results.

For the year ended December 31, 1998, the Company had net operating loss carryforwards for tax reporting purposes in various tax jurisdictions as follows *(in thousands)*:

| | |
|---|---|
| U.S. Federal | DM 32,910 |
| U.S. state | 24,060 |
| German | 11,608 |
| Other | 3,122 |
| Total | DM **71,700** |

In addition, as of December 31, 1998, the Company had U.S. Federal and U.S. state income tax credit carryforwards of approximately DM 46,000 and DM 36,000, respectively. U.S. Federal and state net operating losses carryforwards expire in various periods through 2018. The U.S. federal income tax credit carryforward of DM 46,000 expires in 2012 while the U.S. state income tax credit carryforward of DM 36,000 carries forward indefinitely. The German net operating loss carry forwards for tax purposes relate to corporate income tax and municipial trade tax and carry forward indefinitely. The Tax Reform Act of 1986 and German tax Law contain provisions which may limit the net operating loss and tax credit carryforwards to be used in any given year upon the occurrence of certain events, including a significant change in ownership interest.

## 9. INDUSTRY SEGMENT AND GEOGRAPHIC INFORMATION

During 1998, the Company adopted SFAS No. 131, »Disclosures About Segments of and Enterprise and Related Information.«

The Company is organized based upon the nature of the products and services it offers. Under this organizational structure, the Company operates in two fundamental business segments: product and service. The product segment includes the development and sale of the Company's software products. The service segment provides service and support for the Company's products. The Company's products are primarily developed at its facilities in Jena, Germany, and are sold through a direct sales force and independent distributors in Europe, North America, South America, Australia and Asia.

The information in the following tables is derived directly from the Company's internal financial reporting for corporate management purposes. The Company evaluates its segments' performance based on several factors, of which the primary financial measure is gross margin. Unallocated costs include corporate and other costs not allocated to business segments for management reporting purposes. The accounting policies followed by the Company's business segments are the same as those described in Note 2 to the consolidated financial statements. The Company does not allocate assets by segment for management reporting purposes *(in thousands)*.

| | 1998 | 1997 |
|---|---|---|
| **REVENUES FROM UNAFFILIATED CUSTOMERS:** | | |
| Products | DM 22,092 | DM 5,764 |
| Service | 12,224 | 2,975 |
| Other | 639 | 1,110 |
| Total revenue | DM **34,955** | DM **9,849** |
| **GROSS MARGIN** | | |
| Product | DM 18,595 | DM 2,299 |
| Service | 5,589 | 2,654 |
| Total gross margin | DM **24,184** | DM **4,953** |
| **GEOGRAPHIC INFORMATION IS AS FOLLOWS:** | | |
| **REVENUES FROM UNAFFILIATED CUSTOMERS:** | | |
| Germany | DM 20,011 | DM 7,618 |
| United States | 11,617 | 1,880 |
| Other | 3,327 | 351 |
| Total revenue | DM **34,955** | DM **9,849** |

For the years ended December 31, 1998 and 1997, operations in any single country besides Germany and the United States did not account for more than 10 percent of consolidated net sales.

## 1. GENERAL

The consolidated financial statements of INTERSHOP Communications Aktiengesellschaft (hereinafter referred to as the »Company« or »INTERSHOP AG«) as of December 31, 1998 were prepared as exempting consolidated financial statements in accordance with § 292a of the German Commercial Code (HGB) in conformity with U.S. generally accepted accounting principles (»U.S. GAAP«).

The provisions of the German Commercial Code (HGB) and German Stock Corporation Law (AktG) differ from U.S. GAAP in certain significant respects. The main differences that may be relevant to an evaluation of the net worth, financial position, and the results of the Company are described below:

Pursuant to HGB, all items in the balance sheet and income statement must be set out in the form and order laid down in §§ 266, 275 HGB. U.S. GAAP requires a different presentation, in which the balance sheet items are presented with more liquid items first.

According to U.S. GAAP, the short-term portions of long-term receivables and liabilities are shown in a separate balance sheet item. The portion that falls due in less than one year is treated as short-term.

Purchased software for internal use is not shown as an intangible asset, as it is in financial statements prepared according to HGB, but as property and equipment, such as fixtures, furniture, and office equipment. According to U.S. GAAP, cost to develop software to be sold, leased, or otherwise marketed can be capitalized and amortized over its estimated economic life. According to HGB, internally developed software forming part of fixed assets cannot be capitalized. During 1998, the Company charged all software development costs to research and development as incurred.

## 2. LEASING

According to both HGB and U.S. GAAP, the economic allocation of the leased asset is the basis for the representation of leasing relationships. The criteria for this allocation often vary between HGB and U.S. GAAP, so that in certain cases, a lease asset reported as an operating lease in a balance sheet prepared according to HGB, may be recorded as a capital lease in line with U.S. GAAP. In accordance with U.S. GAAP, the leased asset would then have to be stated in the ba-lance sheet at the present value of the minimum lease payments during the lease term. At the same time, a corresponding liability is also recorded. Depreciation and interest expense in the leasing agreement is then recorded in the income statement.

## 3. DEFERRED TAXES ON LOSS CARRYFORWARDS

According to HGB, deferred tax refund claims arising from loss carryforwards may not be shown on the balance sheet as expected future tax savings are deemed to be not yet realized. According to U.S. GAAP, these types of future tax reduction claims are to be capitalized. Their value depends upon the probability of the loss carryforwards being utilized within the required period. The Company has recorded a valuation allowance for its deferred tax asset due to uncertainties regarding the realization of the asset. .

## 4. EMPLOYEE STOCK OPTIONS

According to U.S. GAAP, stock-based compensation issued to employees may be accounted for in two ways. Under one method, the »fair value« of stock-based compensation may be determined and recorded as an expense over the vesting period of the option or other equity instrument. Alternatively, only the difference between the exercise price of the option and the fair market value of the underlying security on the date of grant are recognized as an expense over the vesting period. Under this method, the pro forma impact on net income of accounting for stock-based compensation using the first method must be disclosed in the financial statements. The Company has elected the latter method and presents the pro forma impact in the notes to the financial statements.

As noted above, the difference between the exercise price of the option and the fair market value of the underlying security on the date of grant are to be treated, according to U.S. GAAP, as personnel expenses recorded ratably over the vesting period of the option and correspondingly recorded under »equity«. In line with currently accepted accounting rules, no expense would occur in the income statement pursuant to HGB.

### 5. EQUITY

According to HGB, the Company would have had to prepare consolidated financial statements for the first time following the acquisition of the majority of shares in INTERSHOP Communications, Inc. on June 22, 1998 and perform the capital consolidation as of this date. The difference between the book value of the participation and the equity capital of the subsidiary INTERSHOP Communications, Inc. would have to be distributed according to the actual value of the assets and liabilities included in consolidation. The remainder would have to be shown as goodwill and either amortized over its expected useful life or offset against the capital reserves on the face of the balance sheet. The valuation base from the Company's individual financial statements would have to be shown as capital stock. The amount allotted to the minority shareholders in INTERSHOP Communications Inc. would have to be shown under the position »equity« as »minority interests in capital« and in the income statement as »minority interests in profit/loss«.

According to U.S. GAAP, the capital consolidation of the Company in line with APB 16 »Business Combinations« is effected as a »transaction under common control«, which eliminates the transfer of the shares in INTERSHOP Communications GmbH, Jena, to INTERSHOP Communications, Inc., as well as the transfer of the shares in INTERSHOP Communications, Inc. to INTERSHOP AG and means that only the amount actually raised is shown as capital stock. Likewise, no differences resulted from these transactions according to U.S. GAAP. Due to the fact that the minority shareholders of INTERSHOP Communications, Inc. have a right of conversion for the conditional capital of the shareholders, no minority shares in the capital or the profit/loss are shown.

Therefore, according to U.S. GAAP, the time of first consolidation does not apply, so that the disclosures made before the formation of INTERSHOP AG reflect the individual group structures.

### 6. REVENUE RECOGNITION

In accordance with U.S. GAAP, sales revenue is recognized in compliance with American Institute of Public Accountants' Statement of Position (SOP) 97-2, »Software Revenue Recognition«, and related interpretations. There is no general difference to HGB with regard to proceeds from licensing. U.S. GAAP requires accounting for work in process on service transactions to be performed according to the »percentage of completion method«, whereby the progress of each project leads to revenue recognition on a pro-rata basis. Service revenue would only be taken into account upon completion of work according to HGB.

### 7. COSTS OF INITIAL PUBLIC OFFERING

According to U.S. GAAP, costs connected with the initial public offering on the stock exchange are to be treated as a reduction of the proceeds from the issuing of stocks. According to HGB, these costs of DM 7.4 Mio. represent extraordinary expenses.

# Management´s Report

# and Financial Statements AG

(HGB)

## CORPORATE DEVELOPMENT

INTERSHOP Communications AG functions as a holding company for its operational INTERSHOP subsidiaries. In the year under review, the company's chief activities consisted of managing these holdings and its own assets.

The company was incorporated on April 23, 1998, and subsequently transformed into INTERSHOP Communications AG on June 16, 1998.

In July 1998, 2,339,100 of a total of 5,194,967 no-par-value shares of INTERSHOP Communications AG were placed on the Neuer Markt of the Frankfurt Stock Exchange. A total of 1,339,100 of these shares stemmed from shareholders, for the most part venture capital shareholders, and 1,000,000 from an increase in capital.

## STOCK OPTION PLANS

At an extraordinary shareholders' meeting held on June 23, 1998, INTERSHOP Communications AG created two stock option plans. The purpose of these stock option plans is to attract new executive officers and employees, to promote loyalty to the company on the part of such personnel and to motivate them to achieve the company's objectives. Due to the existence of differences between the U.S.A. and Europe in terms of the legal situation of stock option plans and the way they are assessed for tax purposes, separate plans were created for employees in the U.S.A. and those in Europe.

## EARNINGS

Since INTERSHOP Communications AG is a holding company, it had no operating revenues in 1998. General administrative expense came to DM 4.4 million, which included expenses incurred for the annual audit and legal and tax advice as well as investor relations. Interest income for the year amounted to DM 1.6 million. Extraordinary expense in connection with Company's stock market listing came to DM 7.4 million, of which DM 5.0 million was accounted for by the fees of the banks that managed the issue and DM 2.4 million by other expense entailed by placement of the Company's shares on the stock market.

## ASSETS AND FINANCIAL SITUATION

At year-end 1998, the fixed assets of INTERSHOP Communications AG consisted exclusively of its holdings in subsidiaries. Current assets essentially consisted of amounts due from subsidiaries in the amount of DM 40.2 million and liquid assets in the amount of DM 62.8 million. These liquid assets represented the net proceeds from the Company's listing on the stock market less loans to affiliated companies that these companies used to repay loans and finance expansion of their business activities.

## SUBSIDIARIES

In 1998, the subsidiaries of INTERSHOP Communications AG expanded their activities, which resulted in a significant increase in both revenues and operating expense. Due to substantial investment in product development, sales, marketing and expansion of their business structures, all of these companies posted losses for the year. INTERSHOP Communications AG made loans to these companies for the purpose of financing further expansion, and these outstanding loans amounted to a total of DM 40.2 million as of Dec. 31,1998.

In December 1998, INTERSHOP Software Entwicklungs GmbH was established in Jena as a wholly owned subsidiary of INTERSHOP Communications AG. Activities intended to develop new technologies will be concentrated in this new subsidiary. Another wholly owned subsidiary, INTERSHOP Communications Ventures GmbH, was also created in Hamburg in the same month. This company will be used to acquire holdings in other companies, in particular providers of innovative software technology.

## THE CURRENT BUSINESS YEAR

In January 1999, 827,200 shares from the conditional capital were approved for trading on the Frankfurt stock exchange (Neuer Markt). A total of 263,954 shares were issued in January 1999. A total of 209,064 shares stemmed from Conditional Capital II and 54,900 from Conditional Capital III. As was mentioned in the Offering Circular prepared prior to the Company's listing on the stock market, Conditional Capital II and III were created to convert outstanding options held by U.S. employees and minority holders of INTERSHOP founder Stephan Schambach and venture-capital investor J. Burgess Jamieson in INTERSHOP Communications, Inc. into INTERSHOP Communications AG shares.

In March 1999, a Swedish subsidiary was created in Stockholm in the context of regional expansion of the Company's business activities. The Swedish subsidiary will substantially reinforce the position of INTERSHOP Communications in the Scandinavian market for electronic commerce applications, which is one of the most important in Europe. In addition, INTERSHOP Communications S.a.r.l., formerly a wholly owned subsidiary of INTERSHOP Communications GmbH, was also acquired by INTERSHOP Communications AG in March to consolidate the INTERSHOP corporate structure. This acquisition took effect retroactively as of January 1, 1999.

## OUTLOOK

The company will continue its efforts to manage its subsidiaries and corporate assets during the remainder of the 1999 business year. Management expects that the company will once again make funds available to subsidiaries to finance expansion , albeit to a significantly lesser extent than in 1998. The company's plans for 1999 call for the acquisition of additional holdings in new companies or in companies that can reinforce the company's position in terms of technology or market share.

INTERSHOP COMMUNICATIONS AG
## BALANCE SHEET AS OF DEC. 31, 1998
*(in DM)*

FINANCIAL STATEMENTS AG
(HGB)

| Assets | | 1998 |
|---|---|---|
| **FIXED ASSETS** | | |
| Financial Assets | | |
| Shares in affiliated companies | DM | 70,160,590.00 |
| **CURRENT ASSETS** | | |
| Accounts receivable and other assets | | |
| Accounts due from affiliated companies | | 40,192,415.14 |
| Other assets | | 626,639.48 |
| | | **40,819,054.62** |
| Cash in banks | | 62,772,758.87 |
| | | 103,591,813.49 |
| **DEFERRED CHARGES** | | 24,579.98 |
| | DM | **173,776,983.47** |

| Liabilities and Shareholders` Equity | | 1998 |
|---|---|---|
| **SHAREHOLDERS´ EQUITY** | | |
| Common stock (conditional capital: DM 9,886,000.00) | DM | 25,974,835.00 |
| Capital surplus | | 156,600,812.00 |
| Net loss | | (10,181,803.87) |
| | | **172,393,843.13** |
| **RESERVES AND ACCRUED LIABILITIES** | | |
| Other reserves and accrued liabilities | | 506,829.49 |
| **LIABILITIES** | | |
| Liabilities due to banks | | 669,646.66 |
| Accounts payable, trade | | 202,081.69 |
| Other liabilities | | 4,582.50 |
| | | 876,310.85 |
| | DM | **173,776,983.47** |

## STATEMENT OF OPERATIONS FOR THE STUB PERIOD FROM APRIL 23 UNTIL DEC. 31, 1998

*(in DM)*



| | | 1998 |
|---|---|---|
| General and administrative expenses | DM | (4,396,640.06) |
| Other operating income | | 98,945.46 |
| Other Interest and similar Income | | 1,550,726.11 |
| thereof from affiliated companies: 594,386.64 | | |
| Interest and similar expenses | | (4,460.91) |
| **RESULT FROM ORDINARY OPERATIONS** | | **(2,751,429.40)** |
| Extraordinary expense | | (7,430,374.47) |
| **EXTRAORDINARY RESULT** | | **(7,430,374.47)** |
| **NET LOSS** | | **(10,181,803.87)** |
| **ACCUMULATED DEFICIT** | DM | **(10,181,803.87)** |

### 1. ACCOUNTING AND VALUATION METHODS

The financial assets were stated at acquisition costs.

Accounts receivable and other assets were stated at par value.

The other provisions and accrued liabilities cover all the recognisable risks. The valuation was made in the amount necessary based upon customary business judgement.

Accounts receivable and accounts payable in foreign currencies were valued using the lower of cost or market principle.

### 2. EXPLANATORY COMMENTS TO THE FINANCIAL STATEMENTS

The development of the financial assets is as follows *(in DM)*:

| | AT COST | | | |
|---|---|---|---|---|
| | Apr. 23, 1998 | Additions | Retirements | Dec. 31, 1998 |
| **FINANCIAL ASSETS** | | | | |
| Shares in affiliated companies | 0.00 | 70,160,590.00 | 0.00 | 70,160,590.00 |
| | **0.00** | **70,160,590.00** | **0.00** | **70,160,590.00** |

| *Continue* | DEPRECIATION FOR THE PERIOD | | | | NET BOOK VALUE | |
|---|---|---|---|---|---|---|
| | Apr. 23, 1998 | Additions | Retirements | Dec. 31, 1998 | Dec. 31, 1998 | Apr. 23, 1998 |
| **FINANCIAL ASSETS** | | | | | | |
| Shares in affiliated companies | 0.00 | 0.00 | 0.00 | 0.00 | 70,160,590.00 | 0.00 |
| | **0.00** | **0.00** | **0.00** | **0.00** | **70,160,590.00** | **0.00** |

The accounts due from affiliated companies as well as other assets have maturities of up to one year.

The capital stock of DM 25,974,835.00 consists of 5,194,967 common bearer shares of no par value. The authorised capital of DM 4,000,000.00 entitles the board of directors to issue further 800,000 common bearer shares of no par value.

There is a total of DM 9,886,000.00 conditional capital at disposal for the issue of 1,977,200 common bearer shares of no par value. Thereof 500,000 shares are reserved for issuing exchange rights to holders of stock options, which the board of directors may grant to employees of the INTERSHOP group.

The capital surplus developed as follows *(in DM)*:

| | 1998 |
|---|---|
| Premium from capital increase by cash contribution | 107,181,572.00 |
| Premium from capital increase by contribution in kind | 49,419,240.00 |
| | **156,600,812.00** |

Other accrued liabilities consist primarily of legal and professional fees.

Liabilities are composed of the following *(in DM thousands)*:

| | REMAINING TERM | | | | Secured by Mortgage Liens |
|---|---|---|---|---|---|
| | Up to 1 Year | 1 - 5 Years | Over 5 Years | Total | |
| Liabilities due to Banks | 670 | 0 | 0 | 670 | 0 |
| Trade accounts payable | 202 | 0 | 0 | 202 | 0 |
| Other liabilities | 5 | 0 | 0 | 5 | 0 |
| | **877** | **0** | **0** | **877** | **0** |

No contingent liabilities or other financial commitments exists.

### 3. OTHER INFORMATION

An average of 2 employees were employed in the stub period of 1998.

The supervisory board in the stub period consisted of:

| | |
|---|---|
| *Dr. Gert Köhler* | Chairman of the supervisory board since May 26, 1998 |
| *Theodore J. Smith* | Vice chairman of the supervisory board since May 26, 1998 |
| *Jörg Menno Harms* | since May 26, 1998 |
| *Birgit Bellmann* | until May 26, 1998 |
| *Marcus Paul* | until May 26, 1998 |
| *Anne Urbahn* | until May 26, 1998 |

The board of directors consisted of:

| | |
|---|---|
| *Stephan Schambach* | Chairman since May 26, 1998 |
| *Wilfried Beeck* | since May 26, 1998 |
| *Bernd Schacht* | until May 26, 1998 |

The board of directors received no remuneration from the company. The remuneration of the supervisory board amounts to DM 20,000.00.

INTERSHOP Communications Aktiengesellschaft is a public listed company and according to Para. 292a HGB, can set up exempting consolidated financial statements in accordance with U.S. GAAP. The consolidated financial statements are deposited at the trade register of the local court in Hamburg. Besides the parent company, the consolidated companies include the following:

INTERSHOP Communications GmbH, Jena

INTERSHOP Communications, Inc., San Francisco, U.S.A.

INTERSHOP Communications S.a.r.l., Paris

INTERSHOP Software Entwicklungs GmbH i.Gr., Jena

INTERSHOP (UK) Ltd., London

INTERSHOP Communications Ventures GmbH, Hamburg

The investments of INTERSHOP Communications Aktiengesellschaft is structured as the following:

| | Share in % | Currency | Equity Dec. 31, 1998 | Net loss 1998 |
|---|---|---|---|---|
| **INTERSHOP** *Communications, Inc. San Francisco, U.S.A.** | 79.26 | DM | (31,563,183) | (32,159,364) |
| **INTERSHOP** *Communications Ventures GmbH, Hamburg* | 100 | DM | 96,427 | (3,573) |
| **INTERSHOP** *Software Entwicklungs GmbH i.Gr., Jena* | 100 | DM | 48,922 | (1,078) |

* The financial statements of INTERSHOP Communications, Inc. have been prepared according to United States generally accepted accounting principles (U.S. GAAP) and include the accounts of this company and its subsidiaries, in particular INTERSHOP Communications GmbH, Jena.

**4. THE IMPLEMENTATION OF THE YEAR END RESULTS**

The board of directors has suggested that the net loss is carried forward.

The Board of Directors

*Stephan Schambach* *Wilfried Beeck*

Hamburg, January 29, 1999

The accounting and the annual financial statements which we have audited in accordance with professional standards, comply with the German legal provisions. With due regard to the generally accepted accounting principles the annual financial statements give a true and fair view of the company´s assets, liabilities, financial position and profit or loss. The management report is consistent with the annual financial statements.

ARTHUR ANDERSEN
*Wirtschaftsprüfungsgesellschaft*
*Steuerberatungsgesellschaft mbH*

| | |
|---|---|
| *Nendza* | *Schneider* |
| *Wirtschaftsprüfer* | *Wirtschaftsprüfer* |

Hamburg, March 5, 1999

## CORPORATE STRUCTURE

- INTERSHOP Communications AG, Hamburg
  - INTERSHOP Communications Ventures GmbH, Hamburg
  - INTERSHOP Software Entwicklungs GmbH, Jena
  - INTERSHOP Communications AB, Stockholm
  - INTERSHOP Communications S.a.r.l., Paris
  - INTERSHOP Communications, Inc., San Francisco
    - INTERSHOP Communications GmbH, Jena
      - INTERSHOP Communications (UK), Ltd., London

*As of march, 1999*

## CORPORATE HISTORY

- **98** Going public
  Launch of new product generation INTERSHOP 3
- **97** Cooperation and license agreement with Deutsche Telekom AG
  Foundation of the group´s international headquaters in the U.S.A.
- **96** Launch of software for eCommerce
  First German Internet company to receive venture capital
- **95** First fully functional Internet retailing solution
- **94** Specialization in Internet applications and electronic commerce
- **92** Foundation of NetConsult Computersysteme GmbH in Jena

# LOCATIONS


As of march, 1999

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