Accelerate into the future!

Annual Report 2003

PSI

PSI develops IT control systems that automate our customer's highly complex core processes in network, production and information management. PSI occupies a leading position on domestic and global markets.

PSI Group in figures (US GAAP)

in € million

	1999	2000	2001	2002	**2003**
Net sales	123.7	146.7	164.9	150.7	**137.7**
Operating result	– 8.5	– 13.4	– 2.2	– 12.4	**0.02**
Earnings before tax	– 8.4	– 13.2	– 1.5	– 19.0	**– 1.5**
Net group result	– 9.0	– 14.8	– 5.1	– 14.8	**– 2.5**
Equity	52.3	65.2	65.6	51.0	**48.5**
Equity ratio (in %)	51.9	46.1	42.9	37.1	**38.5**
Investments	24.5	18.9	11.8	7.7	**6.1**
Research and development costs	12.1	9.1	10.3	11.5	**8.8**
Employees as at Dec. 31 (number)	1,064	1,362	1,405	1,294	**1,193**
Turnover per employee (in €'000)	116	108	117	117	**115**

PSI Group: IT control systems for process automation

Network Management

PSI's software plays a key role in public utilities. Our specialty is our expertise in control technology.

Electricity, Gas, Oil

We are one of Europe's leading enterprises in the electricity, gas, oil and water segments for

- Control systems
- Maintenance management software
- Simulation and network utilization
- Sales and distribution

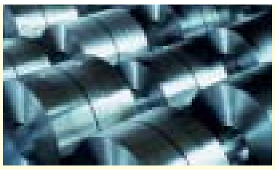
Telecommunications

We are a leading supplier of products and services for

- Network and service management
- Infrastructure
- Test management
- Security management

Production Management

PSI makes production processes manageable. Our specialty is developing production planning control systems for large corporations and mid-sized businesses.



Metals

- PSI is Germany's leading supplier of production management systems in metal production and processing

Process industry

- We are well positioned as suppliers of control systems for the chemical and pharmaceutical industries
- PSI is Germany's leading supplier of production planning systems for printing works

Information Management

PSI improves electronic information processes. Our specialty is agent based technology.

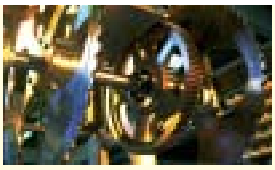
Public administration

- eGovernment: solutions for target agreement controlling, registration and information services, electronic files and integrative organization management.

Transport

We are one of the leading suppliers of control technology applications for traffic systems and transport enterprises:

- Operation control systems for passenger and freight traffic
- Passenger information systems
- Depot management systems



Mechanical engineering and plant construction

- PSI is one of the top suppliers of control systems for mechanical engineering (production planning systems, enterprise resource planning)

Automotive manufacturers and suppliers

- We are excellently positioned as suppliers of production planning and supply chain management systems
- New in 2003: process control system for industrial manufacturing

Logistic companies/airports

- PSI is well positioned as a supplier of management solutions for transport routes, supply depots, virtual central goods and production warehouses, airport logistics, sorting logistics

Industrial service companies

- Professional services automation, staff deployment planning and time recording, corporate portals, virtual assistants based on agent technology

Service companies

- Customer relationship management with portals and agent technology
- Advanced software solutions for IT service companies
- Control systems for managing complex information sources and processes

We gained fresh momentum in 2003 and are firmly back on course for success. PSI is an excellent perspective for our customers, stockholders and employees.

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Dear Stockholders,

Dr Harald Schrimpf (39) became a member of the PSI board in July 2002; he is in charge of marketing, sales and technology. He studied electrical engineering at Aachen RWTH, majoring in technical computer sciences; his doctoral thesis was on distributed real-time operating systems. In 1995, he joined DaimlerBenz Aerospace as technical head of military control software. From 1996, he was responsible for several major IT projects, first as department head and then as main department head. In 2001, he joined gedas, a Berlin-based Volkswagen subsidiary, as Center Manager for Software.

Eighteen months ago we took up the baton as PSI's new Executive Board. Our immediate target was to reverse the negative trend of the past four years and guide PSI back into the black. Despite exceptionally adverse market conditions we succeeded in turning the company around in 2003 and are in a position to report a balanced operating result. We are proud that the company achieved this in a year that was dominated by economic stagnation and the war in Iraq. Several market segments experienced a stop on orders; some of our competitors were forced to pull out. Against this backdrop, we improved our operating result by over €12 million and tripled the price of our stocks from €1.50 to €4.50.

Our new strategy, "From IT portfolio to control systems enterprise", has been the key in bringing about this turnaround. As announced in our last annual report, we are focusing stringently on PSI's core business, a business which has always had a strong, robust substance. Throughout the entire Group and at every level, profitability determines what we do and the decisions that are taken. With this approach we have streamlined loss-making divisions through direct management and have given the company's profitable divisions even greater scope for action.

We succeeded in bridging order shortfalls in specific divisions by putting in place internal load balancing measures. Our foreign subsidiaries were restructured into distribution hubs for the entire PSI Group, a move which swiftly brought them back into the black. We increased our shareholding to 100 % in almost all the subsidiaries that made a positive contribution to our core business of control systems; all non-strategic shareholdings were sold. These measures will enable us to complete the restructuring of the Group by the end of 2004.

Our customers benefit from a comprehensive portfolio of process automation control systems from a single supplier. To secure this valuable advantage, we launched a new level of cooperation between PSI's divisions and subsidiaries. Cross-sales of software between the business units enable us to offer customers a wide array of services, without necessitating substantial extra R&D input. Parallel processes within the Group were identified and merged; the resources released as a result of this move were used to establish new services. We developed a derivative of our PSIpenta software to automate our own business processes; a version aimed at service companies is currently being prepared for market launch. Since 2003, our four-phase model has been applied successfully to all innovative processes throughout the Group.

Armin Stein (52) has been a member of the Executive Board of PSI AG since January 1, 2001, and is in charge of finance, controlling and staff. He studied communications engineering at the Fachhochschule Gießen and business administration at the universities of Frankfurt/Main and Berlin. He began his professional career with AEG, where he worked as commercial director of several technical departments from 1979. In 1989, he was appointed commercial director of AEG Softwaretechnik GmbH in Berlin with full powers of representation; in 1994 his responsibilities were extended to include the Eastern region of AEG Anlagen- und Automatisierungstechnik (Systems and Automation Engineering). From 1997 to 2000, he was on the Executive Board of the repas AEG Group.

A key investment focus in 2003 was on the development and launch of innovative production control systems for high volume manufacturers and steel producers. In 2004, we intend to invest strongly in honing our information management control systems.

The Group's internationalization will be further strengthened by setting up more export partnerships with plant manufacturing enterprises and increasing the level of cooperation with German corporations and their international subsidiaries. We are firmly convinced that this will boost the Group's value considerably, and will enable PSI to aim for a place in the TecDAX index in the near future.

The Executive Board would like to thank all customers, stockholders and staff for their faith in PSI in what have been difficult times. We would also like to pay tribute to the 1,200 people in PSI who in the past year have achieved so much for the Group. They have helped to mold our excellent corporate substance into a new PSI, a PSI that is ready to drive forward into the future.

Dr Harald Schrimpf Armin Stein

Berlin, March 2004

Supervisory Board Report

Dear PSI stockholders,

As the Supervisory Board, we are fully committed to furthering the success of PSI Group. The Group's success is the foundation on which the company's value can flourish. Our responsibility towards the company lies in consistently monitoring the work of the Executive Board in all matters pertaining to PSI Group's strategic alignment and in all important corporate decisions.

The Supervisory Board performed its legal and statutory responsibilities and the duties incumbent upon it under the terms of the German Corporate Governance Code during fiscal year 2003 by duly and regularly supervising the management of PSI AG. It examined all business matters of importance to the corporation and discussed the most significant individual transactions with the Executive Board.

In 2003, the Executive Board and the Supervisory Board focused on the following topics:

- Setting up the new Manufacturing business unit to focus on the automotive industry
- Finalizing alignment measures in PSIPENTA Software Systems GmbH
- The continuation of corporate streamlining efforts by buying back shares in PK Software Engineering GmbH, GSI mbH and front2back AG, and subsequently integrating front2back in PSI UBIS AG
- Realigning PSI UBIS AG to meet evolving demands in the IT markets
- Developing computerized systems to harmonize and expedite intra-enterprise processes

The necessary decisions were taken in eight ordinary meetings of the Supervisory Board. In addition to these ordinary meetings, the staff committee convened twice and the balance sheet committee met twice. The investment committee did not meet in 2003. The Supervisory Board audited its own work at a full-day meeting in December 2003.

PSI Group's risk management system was further refined in 2003. The auditors, Ernst & Young AG, audited the Group's early risk detection system in accordance with Art. 91 Section 2 AktG (German Stock Corporation Act). The Executive Board put in place appropriate measures, including a monitoring system, to ensure that all developments that could potentially pose a threat to the company's continued existence are detected at an early point in time.

We examined the Group and its activities to ensure full compliance with the guidelines and rules of the German Corporate Governance Code. During the audit of the financial statements and the consolidated financial statements the auditors found no indication of non-compliance with the principles of Corporate Governance as laid out in the declaration of conformity.

In a ballot carried out on a rotational basis the Group's employees elected Barbara Simon and Dirk Noß to sit on the Supervisory Board as representatives. The term of the previous employees' representatives, Wolfgang Fischer and Siegfried Hartmann, ended with the 2003 Annual General Meeting. The Supervisory Board would like to thank both for their valuable, constructive input.

At the Annual General Meeting held on June 12, 2003, Ernst & Young AG, certified public accountants, were appointed as auditors. The parent company's financial statements, the consolidated financial statements and the management report for the year ended December 31, 2003, were audited and received an unqualified audit certificate. The Supervisory Board approved the parent company's financial statements, the consolidated financial statements and the management report after discussing them with the auditors and the members of the Executive Board at the Supervisory Board meeting on March 9, 2004. The parent company's financial statements, the consolidated financial statements and the report are thereby adopted.

The prevailing market conditions in 2003 were exceptionally difficult. Against this backdrop, it is all the more laudable that the Executive Board, the management and the Group's employees succeeded in turning around the company and concluding the year with a balanced operating result. The Supervisory Board wishes to thank everyone involved warmly for their commitment and the hard work they contributed to make this possible.

We are confident that the trend-setting work of 2003 has set the pattern for 2004 and that the Group will enjoy another successful year.

In 2004, PSI Group will continue to do its utmost to ensure that our customers remain 100 % satisfied and we will focus every effort on attracting new customers.

Finally, let me conclude by thanking our customers for their continued faith in our company, our products and services.

Christian Brunke
Supervisory Board Chairman

Berlin, March 2004

Corporate Governance

The German Corporate Governance Code presents essential statutory regulations for the management and supervision of German listed companies and contains internationally recognized standards for good and responsible governance. The latest version of the Code is dated May 21, 2003. The purpose of the Code is to promote the trust of national and international investors in German listed companies.

PSI's declaration of conformity with the German Corporate Governance Code can be accessed on the Internet at **www.psi.de/ir**.

The level of trust in our management policies is decisively influenced by the way in which the Group is managed and controlled. All our actions and decisions should display our exceptional level of responsibility and commitment to transparency, and must serve to enhance the value of the company even further. Good Corporate Governance is an elementary component in everything we do at PSI.

The cooperation between the Executive Board and the Supervisory Board is characterized by an exemplary level of efficiency. This is partly because the Executive Board only has two members, allowing us to attain levels of effectiveness that larger boards cannot achieve. It is also due to the extraordinary dedication of the six members of the Supervisory Board, who focus their diverse skills and qualifications on furthering the interests of the company and the stockholders.

PSI maintains more than the required level of transparency – at all levels of the company. All business processes follow clearly defined guidelines. Our corporate communications are very open and transparent: we regularly publish information about all important events in the Group – in printed form, at special events and on the Internet at www.psi.de/ir. In 2003, the IR department also informed investors about developments in the Group in more than 1,000 investor contacts by phone, letter and email.

We believe that the German Corporate Governance Code is a crucial step in bringing corporate management and control in Germany and the regulations that govern this area in line with internationally accepted standards. We welcome the introduction of the Code and its readiness to continually evolve to meet international standards.

Declaration of Conformity with the German Corporate Governance Code

PSI Group is in compliance with the recommendations of the German Corporate Governance Code, Version May 2003, with the following exceptions:

- The company has no spokesperson or chairman of the Executive Board. As the latter consists of two people only, there is no need for a spokesperson or chairman.
- Compensation of the members of the Executive Board is disclosed as a single amount.
- The remuneration paid to the Supervisory Board does not include a performance-related component. The remuneration is based on attendance of the Supervisory Board Meeting and is disclosed as a single amount.

The PSI Stocks

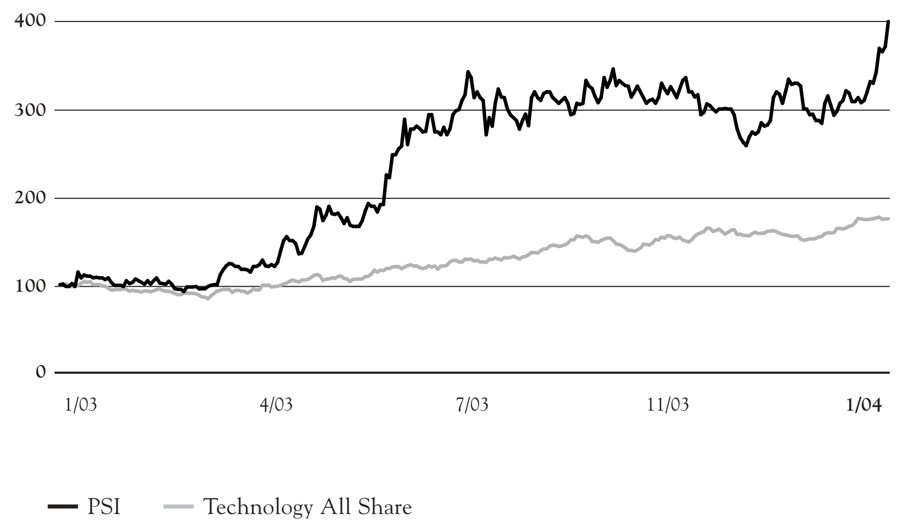
After three consecutive years of losses, the stock markets finally showed signs of reviving in 2003. All benchmark indices showed substantial gains; the German Stock Index DAX improved by more than 1,000 points, which is 37 %. The technology sector displayed positive growth again for the first time. The TecDAX, launched at the beginning of 2003, gained 50 % over the course of the year, while the index relevant for PSI, the Technology All Share index, gained more than 60 %.

PSI stocks overtake the market

PSI stocks started the year at €1.50 and over the course of the next twelve months peaked at €5.38, an increase of more than 250 %. The publication of the 2002 financial statements and the presentation of our new manufacturing control technology at CeBIT in March heralded the upswing: PSI stocks kicked free of the sideways trend which had dominated since fall 2002 and rose above the rest of the market. The publication of the first quarter figures in May saw the continuation of the positive development, with the stocks going on to peak at the year-high. After a prolonged period of sideways movement PSI stocks finished the year at €4.50, exactly tripling in value since the beginning of the year and significantly outperforming all relevant indices. This clearly shows that PSI has bounced back after the disappointments of the past years, and is about to be rediscovered by the capital markets as an attractive high-tech company.

Performance of PSI stocks in 2003 compared with Technology All Share index

in %, January 1 = 100 %



Despite this visible upturn, PSI's current ratings appear to reflect the disappointments of the past, rather than the company's present potential and that of our stocks. To attract more investors we intend to devote 2004 to pushing up our profitability further and boosting the company's value, while also rigorously pursuing our strategic targets.

PSI engages in dialog with the financial market

PSI has belonged to the newly-founded Prime Standard segment of the German Stock Market since the beginning of 2003. As part of this quality segment, which follows international standards, we attach great importance to providing clear, dependable financial market communication. As in past years, this transparency has been rewarded by positive reports about PSI in the key financial and business media. Business development at PSI and the potential of PSI stocks were regularly rated and analyzed by analysts at Baden-Württembergische Bank, DZ Bank, Bankhaus Lampe and First Berlin Equity Research Group. We also successfully presented the company at an investment conference and at the German Equity Forum. To consolidate our investor base we organized several investor roadshows last year, held in key international and domestic financial centers. These measures enabled us to boost the interest of institutional investors in PSI stocks considerably.

PSI stocks in figures

in €

	2002	**2003**
Earnings per share	– 1.40	**– 0.23**
Market capitalization at year-end	16,739,566	**49,557,915**
Year high	9.05	**5.38**
Year low	0.83	**1.40**
Number of shares at year-end	11,012,870	**11,012,870**

Listings:	Xetra, Frankfurt/Main, Berlin-Bremen, Stuttgart, Düsseldorf, Hamburg, Hanover
Stock market segment:	Prime Standard
Indices:	Technology All Share, Prime All Share, Prime Software, CDAX, FTSE eTX All-Share
ISIN:	DE0006968225
German Securitites Code (WKN):	696822
SE symbol:	PSA2

Private investors have access to detailed information about all matters impacting on PSI stocks on our Website at **www.psi.de/ir**. This includes key data, financial reports, analysts' ratings, stock price charts, our financial calendar, information about corporate governance and extracts from press coverage of the Group. Both private and professional investors can sign up here for regular PSI news updates. As in 2002, our Investor Relations activities received an honorable mention for credible financial communications at the German Financial Communications Award in June 2003.

Our middle-term target: admittance to TecDAX

The above-average development of PSI stocks in 2003 catapulted the Group further to the front of German Stock Exchange's index ratings; in terms of market capitalization we are one of the 50 largest technology companies in the Prime Standard segment. We aim to uphold this level of performance over the next few years, then gain admittance to the TecDAX index and secure a long-term listing there. As one of the largest independent software enterprises in Germany, we believe that this would be an adequate reflection of our true market position, as well as giving our stocks the additional attention they deserve.

What the analysts said:

"The restructuring measures are showing visible results"
(Baden-Württembergische Bank)

"The company is on the right path"
(DZ Bank)

"PSI is on course to achieve its targets"
(Bankhaus Lampe)

"Production Management has made commendable progress"
(First Berlin Equity Research)

DR WOLFGANG GALLAS,
Area Manager Asset Management, envia Mitteldeutsche Energie AG

"Our modern PSI control system is an important milestone along the path to optimized network operations."

PSI developed an integrative control system to optimize network operations for the east German power supply company enviaM. In the next phase, enviaM and PSI will be linking the grid system to a geographic data system to create a computerized system capable of optimizing staff deployment routes and times in the network coverage area.

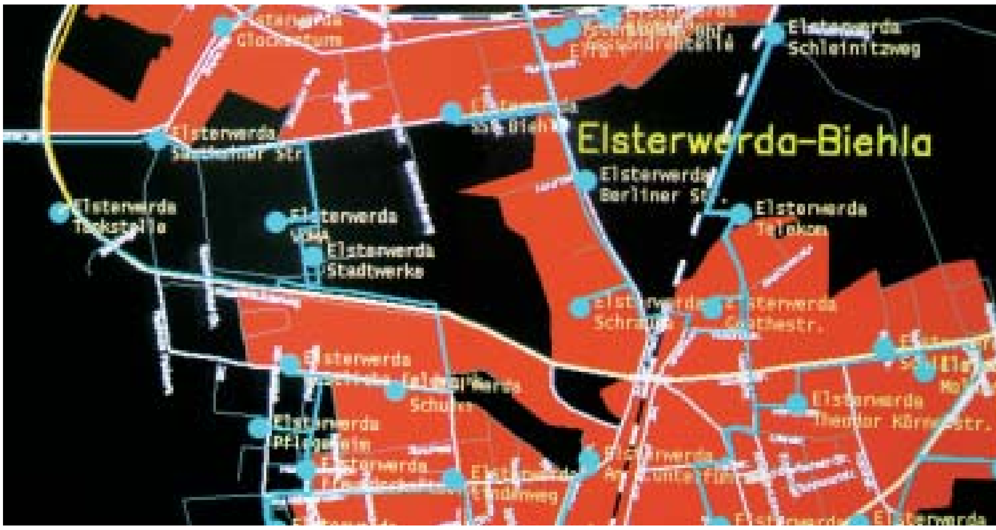
Accelerate into the future!

We've done it. Our results have picked up again and are on the rise. The future looks bright – for our customers, our stockholders and for us. We have established a good, firm basis from which to drive the company forward into a new era. PSI – an innovative driving force in today's markets.

35 years of cutting-edge technology – a four-phase program gets our products fit to compete globally

PSI Group specializes in control systems for utility companies, industrial enterprises and public service companies. We introduced this stringent focus in 2002 and continued to drive it forward in business year 2003. Our range of services has been rounded off, and our products have been extended by introducing important new functions to meet the needs that our customers have today – and the needs they will have tomorrow. We put to use the proven and unique expertise our company has amassed in 35 years. Now the time has come to benefit from this investment in the future.

One of PSI's key strengths is our very special business model: we create customized solutions based on our own products. We are continually developing, evolving and honing these products in order to secure our technological lead. All PSI innovations have two things in common: they are economically effective and close to the market. To ensure that our innovative processes fulfill these demands, we have a four-phase program which has for many years been productively applied in our most successful business units.



Phase One: Individual projects break ground for the rest of the industry

Right from the very start, in the first phase of a product development project, we work closely with leading pilot customers. We supply a solution that mirrors the customer's business and value-added processes. The customer also benefits from the results of our cooperation on research and standardized projects, as these flow into the current project. Examples are our solutions for wireless markets, which were developed in close cooperation with leading telecommunications companies and which almost immediately demonstrated their superior economic efficiency.

Phase Two: Individual follow-on projects spread the new technology

In the second phase we apply the skills and product components of the pilot project to follow-on projects. Our customers in this phase receive individual solutions which reflect the very latest standard of knowledge and are based on proven technology. PSI's own expertise grows with each of these follow-on projects, and this in turn benefits the pilot customers who have access to this expertise for all future product extensions and versions. Such close-knit co-operation makes our systems attractive for both customer circles. A good example is our new maintenance control system for energy supply companies which was developed together with a leading network operator and is now being used by several other customers.

Phase Three: The project hits are turned into products

In phase three we define a product core based on the previous projects; this core is adapted to suit the customer's needs. The customer, mainly mid-sized companies, gets all the benefits of proven advanced technology. For instance, our new software for maintenance management, which was developed together with a major automotive manufacturer and is now available as a preconfigured product for mid-sized companies.

Phase Four: The best products are exported

In phase four we launch our most successful products on the international market in conjunction with major plant construction companies and systems suppliers. By using our products, our export partners gain an additional competitive advantage, and the partnership also opens up an additional distribution and service channel for PSI. For instance, our sector-specific solutions for the steel industry are successfully marketed in conjunction with SMS Demag AG, the world leader in metallurgical plant construction. Currently, PSI products are used in 40 countries worldwide.

PROF DR BURKHARD WELKENER,
Chairman of the Board, Volkswagen Motor Polska

"For many years, PSI solutions have been used in Volkswagen Group to control a variety of production-related tasks. PSI has always been a dependable partner."

Volkswagen AG has been a PSI customer for many years. PSI has supplied more than 20 software solutions to VW, including several technical information systems, a production management system for tooling and maintenance which is used in five sites, logistics systems, production-related information systems and multiple full solutions for special vehicle construction Volkswagen Individual and the motor sports activities at the subsidiary Volkswagen Racing.

By consistently applying our four-phase program to all our new technology developments we are able to open up a very broad base for our products. Our customers benefit from a comprehensive skills pool within their own sector. For PSI, this approach improves the profit potential of innovative products while keeping the risks to a minimum.

For us, using synergies means driving forward into the future together!

In over three decades, PSI has built up a very good market position in clearly defined market segments, an achievement which has been helped along considerably by our decentralized, sector-oriented organization structure. The recent restructuring measures have restored the company's focus to the essentials: all corporate units concentrate on our core business of developing leading process control systems.

We share our concentrated knowledge …

To release the vast synergy potential within the company and tap into it, a number of cross-company working groups were set up last year to examine development, marketing and controlling. The results are used to define company-wide standards, bundle competencies and prevent overlaps.

… and deliver the results to all our markets

At the same time, we introduced a stronger lateral cooperation in marketing between the PSI business units. The aim is to actively market the Group's entire portfolio across all PSI's market segments. This opens up an even wider array of innovative solutions for our customers. The benefits for PSI lie in our ability to boost our sales potential without generating additional development costs. Examples of this efficient intermeshing are our logistics software, which is used in RWE's electricity network unit, and our agent technology, which is used in several logistics projects.

Since 2003, our international activities have focused increasingly on exploiting synergies in the Group's individual business units. Our international branch offices now market the entire PSI portfolio, as well as helping PSI's business units to penetrate foreign markets. They play a key role in expanding PSI's international activities, something which we shall be driving even further forward in 2004.

We transfer successful technologies to other sectors ...

In addition to our cross-unit marketing cooperation we also implemented a technology transfer from our Network Management segment to Production Management. Our control system technology – which continues to demonstrate its dependability and efficiency to energy suppliers in numerous installations – was adapted to meet the needs of the automotive and steel industry in cooperation with industry-leading customers. Our industrial process know-how and expertise in the development of high-end control systems is a unique combination which has enabled us to present a powerful new product.

VOLKER STAHL, DR JÖRG BEINDORF,
Members of the Executive Board, ThyssenKrupp Nirosta GmbH

“PSI is a strong, dependable partner for production IT. PSI’s comprehensive production management system plays a crucial role in optimizing our business processes.”

For almost 20 years, PSI has been designing and supplying ThyssenKrupp Nirosta with solutions to support production processes. The systems cover production management, production planning and control, logistics and energy management in steel mills. They are deployed in the facilities in Krefeld, Dillenburg and Benrath.

DR HANS ESTERMANN,
Managing director, Wirtschaftsförderung Berlin International GmbH

“The portal developed by PSI enables Wirtschaftsförderung Berlin (Berlin Economic Development Corporation) to support investors by providing a unique range of services to communicate the advantages of Germany’s capital.”

PSI developed a universal portal platform for location marketing on behalf of the Berlin Economic Development Corporation. The Business Location Center site flexibly links all relevant data sources and can compile individual show-cases and real-time presentations for individualized investor consultancy.

… and reproduce successful structures within the Group

In 2003, we started simplifying and streamlining our corporate structure to give us greater flexibility to react to market demands. We increased our shareholdings in several subsidiaries to 100 % and integrated front2back AG in PSI UBIS AG. We changed the organizational structure to a profit center based structure in the Public Management division and at PSI Logistics, aligning them with current market conditions. In both divisions the new structure has had a positive impact on earnings. We will be continuing this successful restructuring strategy in 2004, and aim to conclude it by the end of the year.

Cooperation within the Group was significantly improved by introducing an internal bid invitation system and extended capacity management; these measures had a visible impact on the Group's earnings situation. We will continue to align our management structures, for instance by introducing and extending a new company-wide commercial information system. We will continue to transfer our core competence in control systems to other areas, including public security and the IT service company market.

The Group's corporate communications work was further harmonized and this has generated an enhanced awareness on the markets and a substantial gain in efficiency.

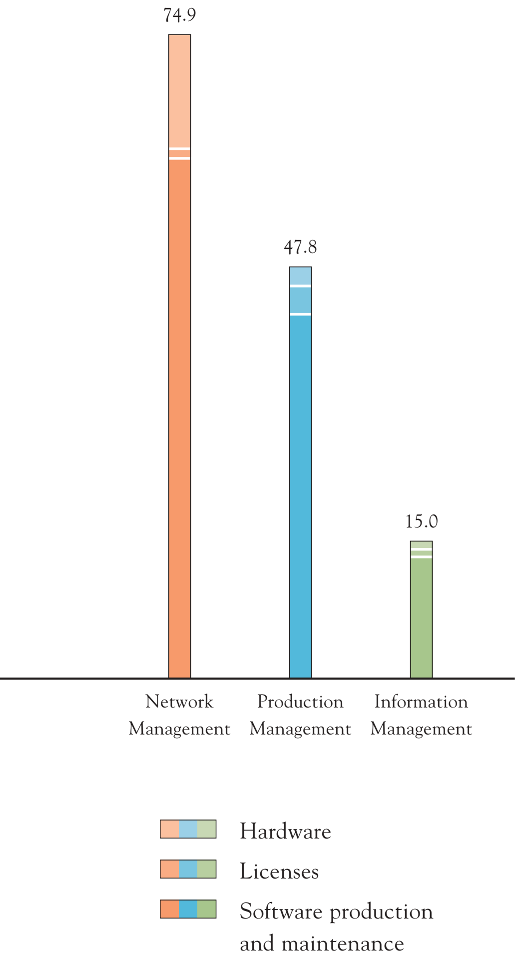
We have made great progress in our endeavor to unite isolated strengths and knowledge within the Group, to rebundle and successfully market them. This has enabled us to reinforce our control system competence still further, an increase which benefits our customers and our stockholders alike.

The path we elected to take last year has proved itself to be the right one. With the superb groundwork of the past year, we now have a solid base from which to accelerate into the future.

Management Report and Financial Analysis (US GAAP)

Management Report and Financial Analysis

Sales of hardware and other manufacturers' software loses significance
(in € million)



Overall economic situation

In fiscal year 2003, PSI faced extremely tough market conditions. At – 0.1 %, Germany's economic performance was in decline for the first time since 1993, after a rise of 0.2 % in the gross national product in 2002. Gross investment in fixed assets, the area PSI is most dependent on as software supplier, declined by 3.3 %. Throughout the euro zone the growth rate shrank by half again compared to the previous year, reaching only 0.4 %.

The western European IT market fell 0.7 % in 2003, the second year of decline in succession. In Germany, the market dropped by 2.1 %, which is three times the European average. The segment that is relevant for PSI – software – displayed a better development than the overall market, growing by 2.1 % in western Europe, but declining a further 0.3 % in Germany.

Altered patterns in the overall conditions of the business environment and cyclical effects forced several market segments serviced by PSI to put a stop on orders and split large projects up into several smaller ones. A cautious reduction in the number of orders on hold became noticeable from fall on.

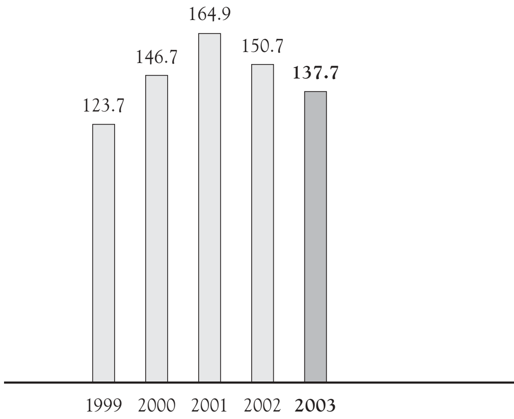
Company development

Despite these unfavorable conditions, for the first time in five years PSI was able to report a balanced operating result in 2003 of €17,000. The consolidated operating result improved by €12.3 million to €– 2.5 million. This amount includes restructuring expenditure and the cost of developing and launching the new manufacturing control systems. The increase in the Group's operating result was largely driven by optimized business processes and the introduction of new products. These are central components in our new corporate strategy, "From IT portfolio to control systems enterprise". Our key focus is on our core business of IT control systems for process automation.

Consolidated turnover dropped by 9 % to €137.7 million (2002: €150.7 million). This is chiefly the result of the decline in sales of hardware and other manufacturers' software. As in previous years, the development of the Group's three segments – Network Management, Production Management and Information Management – displayed varying growth rates.

In our Network Management segment sales dropped by 4 % to €74.9 million. This segment comprises our Energy, Telecommunications and Traffic activities. The operating result decreased by 16 % to €3.8 million compared with the record results of 2002. The negative impact of poor earnings in the Telecommunications segment over the first nine months was particularly noticeable. In 2003, we secured the good position that PSI has in the German market for energy supply companies.

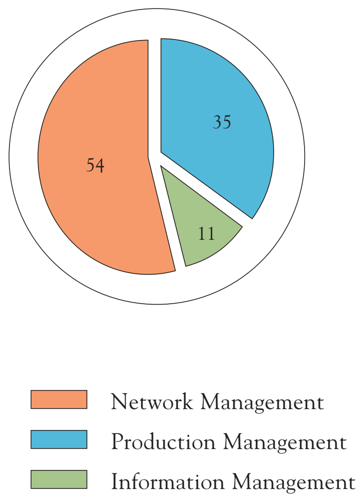
PSI sales
(in € million)



Our Production Management segment reported sales of €47.8 million, which is almost the same as the previous year. This PSI division develops solutions for the control of production and logistics processes. The operating result improved from €13.1 million to €– 1.9 million. This was largely due to the subsidiaries PSI-Logistics, PSI Switzerland and GSI breaking even, and the improvement of PSIPENTA's results.

In 2003, sales in our Information Management division dropped by 38 % to €15 million. The primary focus of this segment is on supporting administrative processes and managing information processes for public authorities and service providers. The operating result remained unchanged at €– 1.9 million. The weak results of our public authorities and UBIS business were the key factors that contributed to this disappointing result. PSI Infrastruktur GmbH and PSI Solutions GmbH were not included in the consolidated financial statements in 2003.

Shares of revenues attributable to Network Management and Production Management have risen
(in %)



The proportion of sales contributed by the Network Management segment rose in 2003 from 52 % to 54 %; the proportion of Production Management increased from 32 % to 35 %; while Information Management dropped from 16 % to 11 %.

The most decisive factor that contributed towards the Group's improved results is the new level of cross-company cooperation between PSI's divisions and subsidiaries. This comprises cross-sales of solutions through all divisions, the automation of our own business processes and the company-wide application of our four-phase innovations program.

In 2003, PSI Group received orders worth €119 million, which is lower than last year's order volume of €136 million. While orders stabilized in Production Management, business in Information Management was very slack, particularly in the summer. Orders in Network Management were affected by the general reluctance of customers to award major projects. The volume of orders received by PSI as at December 31, 2003, was valued at €67 million.

Financing

PSI's share capital increased slightly in 2003 from €28.15 million to €28.19 million. This is the result of a resolution passed at the annual general meeting to increase the share capital out of retained earnings in order to even out the nominal value of non-par value shares. Under the terms of a share buyback scheme agreed at the annual general meeting 17,919 PSI shares were repurchased.

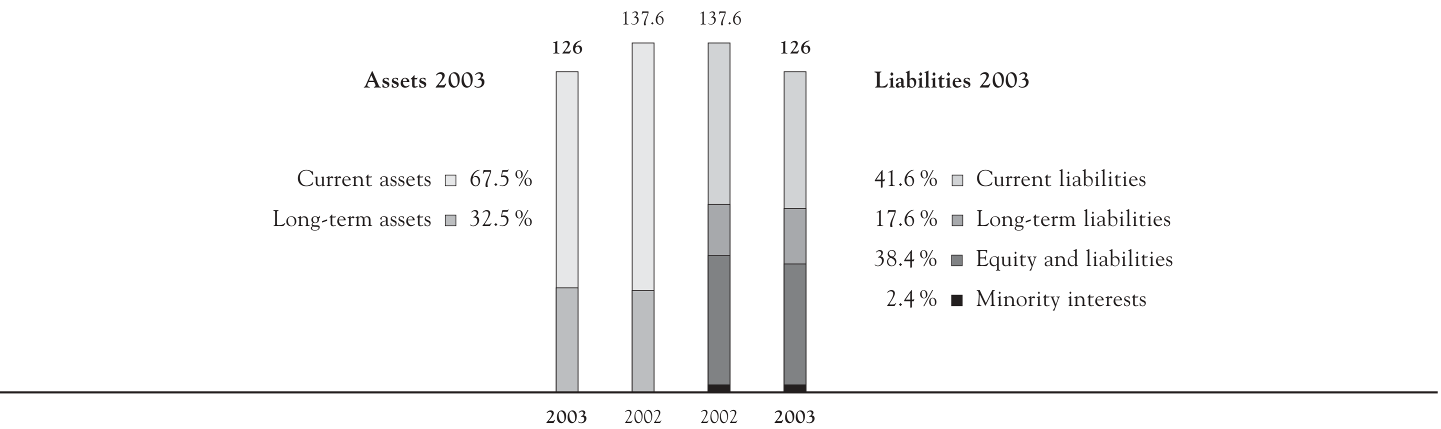
Balance sheet structure

The balance sheet total for 2003 decreased by 8 % to €126 million.

The main changes on both the assets and liabilities sides of the balance sheet were accounted for by current items: the proportion of current assets dropped from 70.6 % to 67.5 % of the balance sheet total. This was largely due to a decrease in unfinished goods and services resulting from the application of the percentage-of-completion method, and also reduced liquidity. The proportion of long-term assets rose from 29.4 % to 32.5 % in the year under review.

The share of current liabilities in the balance sheet dropped from 45.7 % to 41.6 %, largely the result of a decrease in down-payments received by the Group compared to the previous year. The share of long-term liabilities rose from 15.3 % to 17.6 %. 98 % of long-term liabilities are accounted for by pension reserves. The equity ratio went up from 37.1 % to 38.4 %.

Balance sheet structure 2003
(in € million and %)



Liquidity

Liquidity decreased from €21.5 million to €17 million. This is principally the result of a positive operating cash flow of €0.9 million and negative cash flow of €– 5.3 million due to investments. For 2004 we plan to return to generating a positive cash flow from operative business. PSI has sufficient lines of credit with the company's banks.

Investments

In 2003, PSI Group invested €6.1 million, inclusive of financial assets. This decrease of 21 % is partially due to the acquisitions made by the Group in 2002 and a lower level of investment in other intangible assets.

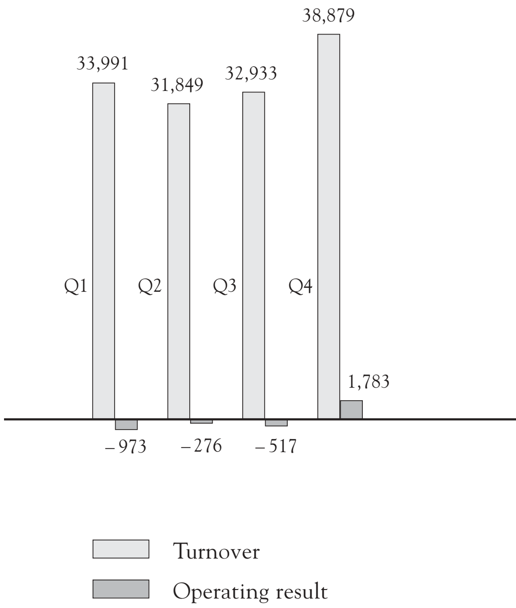
Expenditure for Research & Development was €8.8 million, 24 % less than the previous year. The implementation of the new business processes to refinance PSIpenta product innovations had a positive impact. Since 2003, our successful four-phase program has been applied company-wide to all innovations processes. Key R&D focal areas in 2003 were the new production control system for the automotive and steel sectors; the development of PSIpenta derivatives for service companies and maintenance management; pushing forward the future technology Mobile Common Configuration Management (MCCM) for the wireless market; and the new maintenance control system for network operators. In Network Management R&D spending rose by 6 % to €5.6 million; in Production Management, where there was a greater focus on customer projects, spending dropped by 49 % to €3.2 million.

Potential risks to the Group's future development

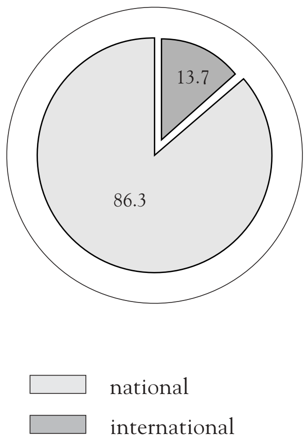
In 2003, PSI implemented and concluded comprehensive restructuring measures in the subsidiaries PSIPENTA Software Systems GmbH and PSI UBIS AG in order to acclimatize these companies to altered market conditions. The future growth of PSI Group's income depends to a large degree on the sustained success of these measures.

In 2003, PSI Group continued to drive forward the internationalization of the Network Management and Production Management segments. An increase in the international success of our products in these segments would lessen the Group's dependency on domestic customers. At the same time, the expansion of international activities has inherent risks (exchange rate risks, dependency on international partners).

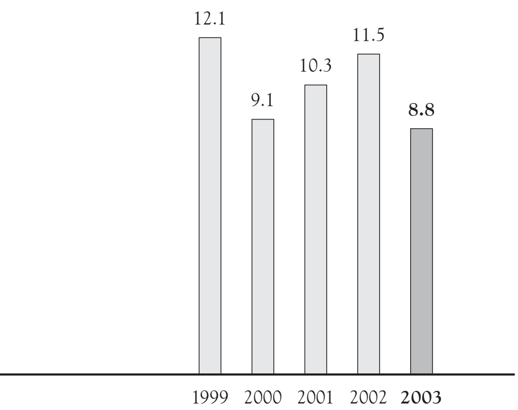
PSI turnover and operating result 2003 by Quarter
(in €'000)



Turnover geographic 2003
(in %)



Research & Development expenditure
(in € million)



PSI Group's financial and earnings situation could be decisively impacted by lawsuits with customers and other parties which were outstanding on the balance sheet date should the courts rule against PSI Group. The Executive Board of PSI AG regularly monitors the status of these lawsuits and is confident – as are the legal advisors retained by PSI Group – that these risks will not all materialize.

The consolidated assets of PSI Group include approximately €25.9 million in goodwill and other intangible assets. They result from the capitalization of software development costs or the identification of intangible assets during the acquisition of other companies. These items account for around 20.5 % of the balance sheet total. Their future value depends on whether the cash flows from the units that report these intangible assets develop as planned.

Risk management
It is of elementary importance for the commercial success of PSI Group that we are able to identify risks and opportunities at an early point, that we evaluate them appropriately and apply suitable measures to avoid any risks and exploit all opportunities.

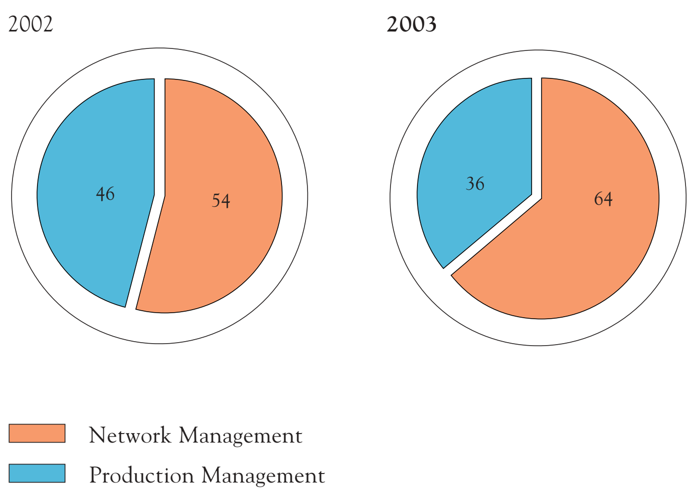
The main threats for the continued success of PSI Group lie in our failing to achieve the targets we have set, particularly in the following segments:

- Market: we may receive too few new orders or our order volume may be too low
- Staff: we may not be able to source personnel with the necessary qualifications
- Liquidity: bad payment conditions and insufficient lines of credit could be detrimental to PSI
- Expenditure and revenues: deviation from projected values, particularly in project management or development, could be detrimental

In fiscal year 2003, we introduced a set of risk management guidelines. These regulations govern risk identification, risk analysis and risk communication, and they define fundamental principles for dealing with any risks that have been identified. Our risk management guidelines are part of PSI's regulatory system and they comprise the following elements:

- Reporting at segment level or at sub-department level
  - Regular monthly reports on the development of the Group's net worth, financial position and results of operations
  - Target/actual comparisons
  - Adjustment of target values to current developments
- Project controlling
  - Legal status of projects
  - Actual results status of projects
  - Status of staff input and capacities
  - Project risks, measures needed to reduce project risks
- Sales forecasts; monitoring the development of markets and the competition
- Capacity management
- Centralized liquidity control for PSI Group
- Senior executives/executive board members of PSI Group are appointed to the supervisory boards/councils of subsidiaries in a controlling capacity

Research & Development expenditure by segment
(in %)

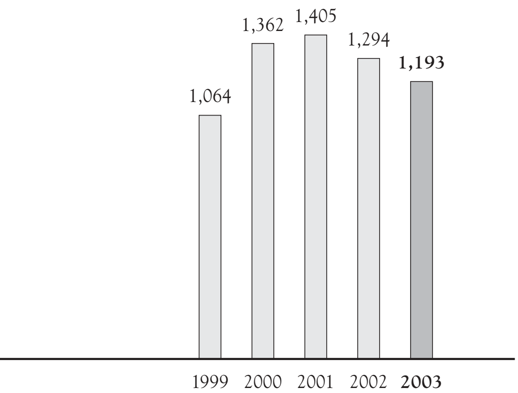


Employees

The skills and motivation of our employees give PSI a decisive competitive edge. A very large proportion of academics with sector specific-skills and qualifications work for PSI Group: around 85 % of our employees hold a university degree.

In 2003, we reduced the number of employees in specific areas of the Group as part of our restructuring strategy to adapt the company to the prevailing weak market conditions. PSIPENTA and PSI UBIS were most affected by headcount reductions. In total, the number of employees in the Group went down to 1,193, a reduction of 101 compared to the previous year. Turnover per employee remained almost unchanged at around €115,000.

Number of employees



We are fully committed to training and developing the skills of our employees by providing internal and external training programs. Training measures have focused on specialized training and on enhancing the project management skills of our employees. Cross-company working groups have been set up to focus on technology, infrastructure, quality management, controlling and marketing, enabling us to promote the exchange of knowledge and technology transfer between the individual business units in PSI Group. This unleashes synergies, which facilitates an even spread of capacities throughout the Group.

For many years now PSI has cooperated very successfully with universities and research institutes. This gives us swift access to emerging technological trends and standards, as well as having the additional benefit of attracting promising young academics to PSI at an early stage.

We remain committed to implementing modern HR concepts, including a variable, performance-related salary system and flexible working hours, thus increasing the level of flexibility, efficiency and motivation among our employees.

The motivation and identification of PSI staff with the company is underscored by the large number of employees who hold shares in the company. Around 35 % of our ordinary stocks are held by employees, of which 7.1 % are held by the employee stockholder pool.

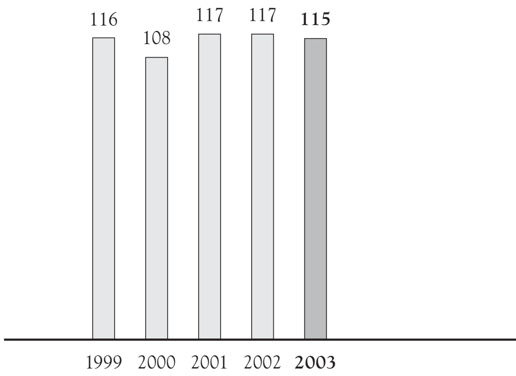
The Board would like to thank all employees for their valuable contribution in what has been a difficult year for the company, and for their commitment in mastering the great challenges we faced in 2003.

Outstanding events in 2003
In the year under review, PSI Group increased its shareholdings to 100 % in the following companies: GSI mbH on March 25, 2003; PSI Logistics GmbH on June 19, 2003; PK Software Engineering GmbH on December 18, 2003. This gives PSI Group full control of these three companies.

On July 1, 2003, the operative business of front2back AG was integrated in PSI UBIS AG. This move bundles PSI's competence in Web portals and Internet services in one single company.

PSI Group set up a new division, PSI Manufacturing, on August 1, 2003, a move which bundles the Group's many years of expertise and skills in control technology and production control in a single division. The new division's first offering, the PSImcontrol control technology system, is an innovative control system for industrial applications.

Turnover per employee
(in €'000)



Events after December 31, 2003
In February 2004, the Group resolved to transform PSI UBIS AG into PSI Information Management GmbH, which remains a 100 % subsidiary of PSI.

Subsidiaries and holdings
PSI's subsidiaries and holdings are detailed in the Notes to the Financial Statements.

Corporate Governance
The Group was monitored in 2003 to ensure compliance with the rule of the German Corporate Governance Code. The Executive Board and the Supervisory Board have issued a declaration of conformity, which is published on the Group's Website. The exceptions are laid out in the section on Corporate Governance (page 6 of this report) and on the Group's Website.

Outlook

The measures introduced at the end of 2002 have gripped, resulting in a tangible increase in the Group's income. These measures have also paved the way for a sustained, enduring improvement to the Group's earnings situation. For 2004, we anticipate muted economic development and the continued retrenchment of the IT market. For the current fiscal year, we are aiming to increase our revenues still further and are targeting sales on par with 2003. As an independent product manufacturer, PSI stands to benefit more than other companies from the recovery of the markets which has been forecast by industry associations.

2004 will be the year in which we actively tackle all outstanding issues within the Group and conclude the streamlining of the company's structures. Investment in our core competencies will continue unabated, and we will be transferring our successful control system technology to other market segments. We are confident that this will generate crucial future growth impulses. One investment focus in 2004 will be on the development of control systems for information management processes.

For our Network Management division, 2004 brings the imminent regulation of the German energy market, opening up valuable additional potential for our company. At the same time, the reluctance to invest in the face of regulation poses a certain threat. The eastern extension of the EU will also expand PSI's potential market. However, we also expect the accession to trigger the start of fiercer competition in the programming and IT services sector.

We will continue the drive for internationalization started in previous years with our existing partners, and intend to set up more partnerships with plant construction companies, German corporations and their foreign subsidiaries.

Over the next years PSI will become an internationally leading supplier of high-end process control solutions for network operators, industrial customers and government authorities. Our confidence is driven by PSI's valuable core strengths, not least the competence of our staff and the high quality of our software products. Given the company's current stock market valuation, we believe that our stocks still have great potential to increase substantially in value and outperform the competition in 2004 and the coming years.

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Consolidated Balance Sheet

ASSETS	Note	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Current assets			
Cash and cash equivalents		16,970	21,532
Trade receivables net of allowances for doubtful accounts of EUR 330 k (2002: EUR 369 k)		29,535	29,938
Costs and estimated earnings in excess of billings on uncompleted contracts	4	31,640	36,723
Inventories	5	2,787	3,662
Prepaid expenses		1,709	1,882
Other receivables	6	2,406	3,368
Total current assets		**85,047**	**97,105**
Non-current assets			
Financial assets	7	5,851	6,015
Property, plant and equipment (net)	8	9,291	10,296
Intangible assets (net)	8	25,857	24,155
Total non-current assets		**40,999**	**40,466**
Total assets		**126,046**	**137,571**

LIABILITIES AND SHAREHOLDERS' EQUITY	Note	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Current liabilities			
Financial debts	9	5,360	3,540
Trade payables		8,469	8,616
Billings in excess of costs and estimated earnings on uncompleted contracts	4	11,812	22,120
Deferred income		5,649	6,499
Other current liabilities and accrued expenses	10	20,477	21,105
Deferred tax liabilities	15	679	934
Total current liabilities		**52,446**	**62,814**
Long-term liabilities			
Pension reserves	11	21,734	20,525
Financial debts	9	393	522
Other long-term liabilities		0	41
Total long-term liabilities		**22,127**	**21,088**
Minority interests		**2,981**	**2,624**
Commitments and contingencies	14		
Equity			
Subscribed capital; EUR 2.56 calculated par value; authorized shares 3,879,684 (2002: 3,879,684); issued shares 11,012,870 (2002: 11,012,870); outstanding shares 10,994,951 (2002: 11,012,870)	12	28,193	28,154
Capital reserves		30,898	71,765
Other reserves		1,181	1,220
Accumulated loss		– 11,098	– 49,437
Subtotal		**49,174**	**51,702**
Treasury stock		– 73	0
Accumulated other comprehensive income	2	– 609	– 657
Total equity		**48,492**	**51,045**
Total equity and liabilities		**126,046**	**137,571**

Consolidated Statement of Income

	Note	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Sales			
Software production and maintenance	16	117,187	122,689
Licenses	16	5,292	7,418
Hardware	16	15,173	20,608
		137,652	**150,715**
Cost of sales			
Software production and maintenance		91,343	99,755
Licenses		1,295	2,592
Hardware		13,106	17,563
		105,744	**119,910**
Gross profit		**31,908**	**30,805**
Operating expenses			
Selling expenses		17,095	21,232
General and administrative expenses		7,225	10,152
Research and development costs, net		7,556	10,916
Depreciation of capitalized software development costs		562	713
Other income and expenses		– 547	226
		31,891	**43,239**
Operating result		**17**	**– 12,434**
Interest and investment result		– 1,565	– 1,136
Effect of change in accounting standards		0	– 5,395
Income before income taxes and minority interests		**– 1,548**	**– 18,965**
Income taxes	15	– 623	4,073
Minority interests		– 357	82
Net Group loss for the year		**– 2,528**	**– 14,810**
Basic and diluted earnings per share			
in euro per share		– 0.23	– 1.40
Share basis for calculation of basic and diluted earnings per share (thousand of shares)		11,011	10,601

Consolidated Cash Flow Statement

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Cash flow from operating activities		
Net Group loss for the year before minority interests	– 2,171	– 14,892
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation of property, plant and equipment and amortization on intangible assets	4,713	5,399
Impairment losses on goodwill	0	5,395
Write-downs of associated companies and other financial assets	720	1,530
Addition to pension reserves	1,209	1,581
Deferred taxes	– 255	– 4,175
Other non cash-related expenses	– 327	0
Minority interests	0	82
Changes in assets		
Trade receivables	403	15,105
Costs and estimated earnings in excess of billings on uncompleted contracts	5,083	– 1,300
Inventories	875	4,355
Prepaid expenses	173	– 814
Other receivables	962	3,293
Changes in liabilities		
Short-term operational financial liabilities	1,820	– 3,409
Trade payables	– 147	– 6,825
Billings in excess of costs and estimated earnings on uncompleted contracts	– 10,308	5,792
Deferred income	– 850	2,315
Other reserves and accrued liabilities	– 970	1,089
	930	**14,521**
Cash flow from investing activities		
Cash paid for additions to financial assets (net of cash acquired)	– 320	– 818
Additions to property, plant and equipment and other intangible assets	– 3,542	– 4,516
Payment for purchase of companies, net of cash acquired	– 77	0
Additions to capitalized software development costs	– 1,399	– 628
	– 5,338	**– 5,962**
Cash flow from financing activities		
Acquisition of treasury stock	– 73	0
Cash paid/received from bank loans	– 129	398
	– 202	**398**
Changes in cash and cash equivalents due to exchange rates and valuation	48	– 298
Changes in cash and cash equivalents	**– 4,562**	**8,659**
Cash and cash equivalents at the beginning of the fiscal year	**21,532**	**12,873**
Cash and cash equivalents at the end of the fiscal year	**16,970**	**21,532**
Supplemental cash flow information		
Interest payments	392	401
Tax payments	837	203

Consolidated Statement of Changes in Shareholders' Equity

	Number of shares issued and outstanding (at calculated value of 2.56 EUR)	Common stock EUR k	Capital reserves EUR k
As of December 31, 2001	**10,126,160**	**25,887**	**68,006**
Net Group loss for the year			
Foreign currency translation			
Issuance of shares			
Contribution of 100 % of Büsing & Buchwald GmbH for issuance of shares	200,000	511	429
Registration in the commercial register			
Contribution of 40 % of PSIPENTA Automotive GmbH for issuance of shares	161,710	414	1,365
Contribution of 25 % of UBIS AG for issuance of shares	525,000	1,342	1,965
Waiver of capital increase (entry of the contribution of 21.6 % of the shares in PSI AG/Switzerland)			
Unrealized losses from financial investments			
As of December 31, 2002	**11,012,870**	**28,154**	**71,765**
Net Group loss for the year			
Capital increase through conversion of other reserves to reassess the inputed par value per share		39	
Purchase of treasury stock			
Offsetting of statutory losses and capital reserves			– 40,867
Unrealized losses from financial investments			
Foreign currency translation			
As of December 31, 2003	**11,012,870**	**28,193**	**30,898**

Contribution made for capital increase EUR k	Other reserves EUR k	Treasury stock EUR k	Components of comprehensive income			Total share-holders' equity EUR k
			Retained earnings/ accumulated deficit EUR k	Accumulated other comprehensive loss EUR k	Total comprehensive loss EUR k	
5,428	**1,220**	**0**	**– 34,627**	**– 359**	**– 5,372**	**65,555**
			– 14,810		– 14,810	– 14,810
				– 26	– 26	– 26
						940
– 1,779						0
– 3,307						0
– 342						– 342
				– 272	– 272	– 272
0	**1,220**	**0**	**– 49,437**	**– 657**	**– 15,108**	**51,045**
			– 2,528		– 2,528	– 2,528
	– 39					0
		– 73				– 73
			40,867			0
				– 1	– 1	– 1
				49	49	49
0	**1,181**	**– 73**	**– 11,098**	**– 609**	**– 2,480**	**48,492**

Consolidated Fixed Assets Movement Schedule

	Aquisition and production cost Jan. 1, 2003 EUR k	 Additions EUR k	 Disposals EUR k	 Dec. 31, 2003 EUR k
Property, plant and equipment				
Land and buildings	12,262	11	0	12,273
Computers and accessories	13,891	1,462	2,547	12,806
Office equipment	5,347	229	484	5,092
	31,500	**1,702**	**3,031**	**30,171**
Intangible assets				
Other intangible assets	17,584	1,871	274	19,181
Goodwill	29,271	601	0	29,872
Capitalized software development costs	24,103	1,399	24	25,478
	70,958	**3,871**	**298**	**74,531**
	102,458	**5,573**	**3,329**	**104,702**

Segment Reporting

	Network Management Dec. 31, 2003 EUR k	 Dec. 31, 2002 EUR k
Sales		
Software production and maintenance	60,444	58,633
Licenses	1,303	1,993
Hardware	13,112	17,573
	74,859	**78,199**
Gross profit	**17,611**	**18,995**
Operating expenses	13,831	14,491
Operating result before taxes and minority interests	3,164	4,442
Net loss/income for the year (before minority interests)	**2,987**	**8,182**
Other disclosures		
Depreciation and amortization (scheduled)	2,472	2,774
Impairment	0	0
Non-current assets	28,516	29,432
Goodwill	14,264	14,264

	Accumulated Depreciation				Net book values	
	Jan. 1, 2003 EUR k	Additions EUR k	Disposals EUR k	Dec. 31, 2003 EUR k	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
	5,141	341	0	5,482	6,791	7,121
	12,295	1,639	2,453	11,481	1,325	1,596
	3,768	590	441	3,917	1,175	1,579
	21,204	**2,570**	**2,894**	**20,880**	**9,291**	**10,296**
	12,770	1,499	272	13,997	5,184	4,814
	11,626	0	0	11,626	18,246	17,645
	22,407	644	0	23,051	2,427	1,696
	46,803	**2,143**	**272**	**48,674**	**25,857**	**24,155**
	68,007	**4,713**	**3,166**	**69,554**	**35,148**	**34,451**

	Production Management		Information Management		PSI Group	
	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
	42,266	41,480	14,477	22,576	117,187	122,689
	3,647	4,742	342	683	5,292	7,418
	1,884	2,071	177	964	15,173	20,608
	47,797	**48,293**	**14,996**	**24,223**	**137,652**	**150,715**
	12,920	**9,562**	**1,377**	**2,248**	**31,908**	**30,805**
	14,794	24,593	3,266	4,154	31,891	43,238
	–2,709	–17,824	–2,003	–5,583	–1,548	–18,965
	–3,239	**–17,429**	**–1,919**	**–5,645**	**–2,171**	**–14,892**
	1,745	2,017	496	608	4,713	5,399
	0	2,075	0	3,609	0	5,684
	8,860	8,009	3,623	3,025	40,999	40,466
	1,981	1,681	2,001	1,700	18,246	17,645

Notes to the Consolidated Financial Statements as of December 31, 2003

The company

1. Business activities and legal background

The business activities of PSI AG (hereinafter referred to as “Company” or “PSI AG”) and its subsidiaries (hereinafter referred to as “PSI Group”) relate to the development and sale of software systems and products fulfilling the specific needs and requirements of its customers, particularly in the following industries and service lines: utilities, manufacturing, telecommunications, traffic, authorities, software technology, internet applications and business consulting. In addition, the PSI Group offers data processing services and distributes electronic devices.

The PSI Group is divided into the main business lines (segments) network management, production management and information management.

The Company is exposed to a wide range of risks that are similar to other companies active in the dynamic technology sector. Major risks for the development of the PSI Group lie in the success with which it markets its software systems and products, competition from larger companies, the ability to generate sufficient cash flows for future business development as well as in individual risks regarding the integration of subsidiaries, organizational changes and the cooperation with strategic partners.

Main customers are utility, telecommunication and manufacturing companies in Germany and Europe.

The Company has its headquarters in Berlin where it has been registered at the commercial register, department B under No. HRB 51463.

Main locations with business activities are located in Berlin, Aschaffenburg, Essen, Dortmund, Düsseldorf, Karlsruhe and Neviges.

2. Summary of significant accounting and valuation principles

Basis of presentation
The consolidated financial statements of PSI AG have been prepared in accordance with accounting principles generally accepted in the United States (“US GAAP”).

Consolidation principles

The assets, liabilities and results of operations of entities in which the Company has a controlling interest have been consolidated. All material intercompany accounts and transactions have been eliminated for consolidation purposes.

Use of estimates and assumptions

The preparation of the financial statements in compliance with US GAAP requires the management board to make estimates and assumptions which have an effect on the amounts disclosed in the balance sheet, on the disclosure of contingent receivables and liabilities at closing date, and on the earnings and expenses disclosed during the reporting period. The actual results may deviate from these estimates and assumptions.

Associated enterprises

Investments in which the Company exercises significant influence but does not control (generally 20-50 % ownership interest) are accounted for under the equity method of accounting.

Foreign currency translation adjustment

Currency translation is performed according to the Statement of Financial Accounting Standards (“SFAS”) No. 52 “Foreign Currency Translation”. According to this standard the assets and liabilities of the subsidiaries are translated into euro at the exchange rate prevailing on the balance sheet date and the income statement is translated using the annual average exchange rate. Equity of the participations is translated at the historical exchange rate. Any differences arising from the application of different currency exchange rates are recorded for the period of affiliation without any effect on profit and reported separately in the equity section. Ongoing gains and losses on transactions in foreign currency are recorded in the operating statement.

Revenue recognition

The Company generates its revenues mainly from the licensing of the rights to use its software products to end users, both with and without customization. The Company also generates revenues from sales of third party software and hardware as well as other services, including installation, consulting, training and maintenance.

Revenue from licenses is recognized in accordance with the Statement of Position (“SOP”) 97-2 “Software Revenue Recognition” of the American Institute of Certified Public Accountants –, as amended and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 101, “Revenue Recognition in Financial Statements”. Revenue from licenses is recognized if there is sufficient evidence that a contractual agreement exists, delivery has occurred, the license fee is fixed or determinable and the collection of the fee is probable. Revenue from maintenance agreements is realized on a straight-line basis over the term of the agreement based on past experience. Income from consulting services and training is recognized as soon as the service has been rendered. Revenue on arrangements that include multiple elements such as hardware, software, and services is allocated to each element based on vendor specific objective evidence (VSOE) of the fair value of each element. Allocated revenue for each element is recognized when revenue recognition criteria have been met for each element. VSOE is determined based on the price charged when each element is sold separately.

Revenue from project business is recognized in accordance with SOP 97-2. SOP 97-2 requires arrangements to deliver software systems to be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45 "Long-Term Construction-Type Contracts" using the relevant guidance therein, and in SOP 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" if significant modification or customization is involved. For long-term construction type contracts which meet the criteria of the percentage of completion method, revenues from the development and sale of software systems and products is deferred and recognized under the percentage of completion method of accounting as the project is performed. Percentage of completion is measured by the ratio of labor cost incurred to the total estimated labor cost or on a milestone basis. Payments received from customers on account of orders are offset against the corresponding receivables items without an effect on income. Revenue from short-term construction type contracts is recognized according to the completed contract method upon partial or final acceptance and final billing of the project. Changes in project conditions may result in revisions to previously recorded costs and revenues for a particular project. These changes are recognized in the period in which the revisions are determined; this generally occurs when formal change orders are signed between the Company and the customer. Furthermore, provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined.

The Group adopted Emerging Issues Task Force ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables", in the third quarter of fiscal year 2003. The impact of adopting EITF 00-21 was not material to the Company's results of operations.

Product-related expenses

Expenses for advertising and sales promotion as well as other sales-related expenses are recorded with effect on income as they are incurred. Accruals for warranties are established when the products are sold. Research and development are expensed as incurred – unless capitalization is required pursuant to SFAS No. 86 "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed".

Advertising and sales promotion expenses amounted to EUR 1.933k (2002: EUR 2.816k).

Net earnings (loss) per share

Basic earnings per share are computed in accordance with SFAS No. 128 "Earnings per Share" using income available to holders of common shares divided by the weighted average of common shares outstanding during the year. Diluted earnings per share are similar to basic earnings per share except that the weighted average of common shares outstanding is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares, such as options, had been issued. The cumulative effect of accounting change for earnings per share were EUR – 0.51 in 2002. For the years ended December 31, 2003 and 2002, 108,300 and 291,850 stock options, respectively, were excluded from the calculation of diluted EPS because the effect was anti-dilutive.

Cash and cash equivalents

Cash and cash equivalents comprise cash on hand, current bank balances as well as deposits that can be cashed at short notice with original terms of three months or less.

Inventories

Inventories comprise purchased hardware and licenses belonging to third parties that are to be sold, which are carried at acquisition cost, and work in progress, which is valued according to the completed contract method. Inventories are shown at the lower of cost or market. In fiscal year 2003 valuation allowances were established totaling EUR 175k (EUR 514k in 2002).

Fair value of financial instruments

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and long-term debt approximate their fair values. All balances within accounts receivable are due within one year.

The Company classifies its existing marketable equity securities as available-for-sale and discloses them at market value. Unrealized gains and losses from available-for-sale securities are reported in other comprehensive income, net of income tax effects. The gains and losses realized are calculated for every sale and disclosed with an effect on income. The Company defines permanent impairment at each balance sheet date on the basis of various factors, including the length of time over which the market value of the securities was lower than their acquisition cost and a special analysis and valuation for each security.

Concentration of credit risks

The Company offers its services to a large number of customers, operating in various industries and geographical regions. There are no customer receivables with significant concentrations of credit risks.

Intercompany transactions

Transactions between companies in the PSI Group are carried out at market prices.

Long-lived assets

a) Property, plant and equipment

Property, plant and equipment is recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method of depreciation over the useful lives of the respective classes of assets as follows:

	Useful life/depreciation rate	Method
Buildings and land improvements	10-50 years	Straight-line
Leasehold improvements	3-15 years	Straight-line/term of rental agreement
Computers and accessories	3-4 years	Straight-line
Furniture and equipment	5-13 years	Straight-line

Cost includes major expenditures and replacements which extend useful lives or increase capacity and interest costs associated with significant capital additions. For all periods presented, the interest costs allocable to these projects are insignificant and thus not capitalized. When plant or equipment is sold or scrapped, its residual value after deducting accumulated depreciation from historical cost is written off. Gains and losses on the disposal of assets are posted to earnings. Maintenance and minor repairs are charged to operations as incurred, while expenses leading to a significant improvement or complete renewal are capitalized.

Leasehold improvements are amortized over the shorter of their estimated useful life or the life of the lease. Equipment covered by capital leases is depreciated over its estimated useful life. Useful lives are re-estimated regularly by management in order to determine recoverability in light of current technological conditions.

The Company reviews the carrying amount of long-lived assets (property, plant and equipment, definite lived intangible assets) if there is any indication that the carrying amount of the asset is impaired. The recoverability of long-lived assets other than goodwill is assessed by comparing the carrying amount of the respective asset with the expected undiscounted cash flows that can be generated from the asset. If the carrying amount is lower than the sum of undiscounted cash flow an impairment is recorded equal to the difference between the carrying amount and the undiscounted cash flow.

In fiscal years 2003 and 2002, an impairment of EUR 0k and EUR 289k was recorded for long-lived assets.

b) Intangible assets and goodwill

Intangible assets comprise goodwill, capitalized software development costs and other intangible assets (software and licenses).

Goodwill

Goodwill is the difference between the purchase price of a business less the fair value of the net tangible and separately identifiable intangible assets. Effective January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets". As required under SFAS No. 142, we no longer amortize goodwill.

Impairment testing for goodwill is performed at least annually unless indicators of impairment exist. Examples of such indicators, as outlined in SFAS No. 142 include: a significant adverse change in legal factors or the business climate; an adverse action or assessment by a regulator; unanticipated competition; a loss of key personnel; a more likely than not expectation that a reporting unit or a significant portion of a reporting unit will be sold; a recoverability test under SFAS No. 144 was performed for an asset or group within a reporting unit; and a goodwill impairment loss is recorded by a subsidiary that is a component of a reporting unit.

The impairment test for goodwill uses a two-step approach, which is performed at the reporting unit level. Step one compares the fair value of the reporting unit (calculated using a discounted cash flow method) to its carrying value. If the carrying value exceeds the fair value there is a potential impairment and step two must be performed. Step two compares the carrying value of the reporting unit's goodwill to its implied fair value (i.e. fair value of reporting unit less the fair value of the unit's assets and liabilities, including identifiable intangible assets). If the goodwill's carrying value exceeds its implied fair value, the excess is required to be recorded as an impairment.

In fiscal year 2003, no impairment was recorded related to goodwill. The initial impact of adopting SFAS No. 142 on our consolidated financial statements was recorded as a cumulative effect of an accounting change as of January 1, 2002, resulting in a charge of EUR 5,395k, net of tax.

Capitalized software development costs

The Company accounts for internally generated software development costs for the development of new software products and of significant improvements to existing software products in accordance with SFAS No. 86, “Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed”. 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 completion of beta testing of the software. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs requires considerable judgment 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. Capitalized software development costs are depreciated at the higher of the following two amounts:

- straight-line over the estimated useful life of the software (four years) or
- in proportion of the current gross revenue from the sale of the software to the total amount of current and estimated future gross revenue from the sale of this software.

Other intangible assets

Intangible assets are valued at cost less accumulated amortization. Amortization is computed using the straight-line method over the estimated useful lives of three to ten years.

Deferred taxes

The Company accounts for taxes on income according to the liability method, in compliance with SFAS No. 109 “Accounting for Income Taxes”. When applying the liability method, deferred taxes are defined on the basis of temporary valuation differences in the recognition of items in the consolidated financial statements and the tax accounts. In this case, the taxation rate to be applied is the one valid for the year in which the effect is reversed. Deferred tax assets are provided for tax-deductible net loss carryforwards. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that such assets will not be realized.

Stock-based compensation

The Company accounts for stock-based compensation using the intrinsic value method prescribed in APB 25 “Accounting for Stock issued to Employees” which are more fully described in Note 13 “Stock-based compensation”. Compensation cost for stock options is measured as the excess of the quoted market price of the Company’s stock on the measurement date over the amount an employee must pay to acquire the stock. These costs are recognized as expenses in the period before the options are exercised. The Company’s plans satisfy the criteria of a “fixed plan” pursuant to APB 25.

SFAS No. 123 "Accounting for Stock-Based Compensation" established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. The Company has elected to retain the method of accounting as described above, and has adopted the disclosure requirements of SFAS No. 123.

Had compensation cost for these plans been determined in accordance with SFAS No. 123, the Company's net loss and net loss per share would have been:

	2003 EUR k	2002 EUR k
Net Group loss for the year	– 2,528	– 14,810
Add: Stock based employee compensation expense included in reported net income, net related tax effects	0	0
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects	– 198	– 336
Pro-forma Net Group loss for the year	– 2,726	– 15,146
Earnings per share in EUR		
basic & diluted – as reported	– 0.23	– 1.40
basic & diluted – pro forma	– 0.25	– 1.43

The pro-forma results presented above are not indicative of future period pro-forma results.

Comprehensive income

Accumulated other comprehensive income as of December 31, 2003 consists of the following:

	Dec. 31, 2002 EUR k	Change 2003 EUR k	Dec. 31, 2003 EUR k
Foreign currency translation adjustment	– 274	49	– 225
Unrealized loss on available-for-sale securities	– 383	– 1	– 384
	– 657	**48**	**– 609**

Recent accounting pronouncements

The Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities", in January 2003 and amended the Interpretation in December 2003. FIN 46 requires an investor with a majority of the variable interests (primary beneficiary) in a variable interest entity (VIE) to consolidate the entity and also requires majority and significant variable interest investors to provide certain disclosures. A VIE is an entity in which the voting equity investors do not have a controlling financial interest or the equity investment at risk is insufficient to finance the entity's activities without receiving additional subordinated financial support from the other parties. Development-stage entities that have sufficient equity invested to finance the activities they are currently engaged in and entities that are businesses, as defined in the Interpretation, are not considered VIEs. The provisions of FIN 46 were effective immediately for all arrangements entered into with new VIEs created after January 31, 2003, and the Company has elected to apply the remaining provisions of the Interpretation for the period ending December 27, 2003. The Company has completed a review of its investments in both non-marketable and marketable equity securities as well as other arrangements to determine whether PSI AG is the primary beneficiary of any VIEs. The review did not identify any VIEs that would require consolidation or any significant exposure to VIEs that would require disclosure.

Changes of principles of classification

The classification of certain items in the consolidated financial statements of the Company has been changed compared to the previous year. The new classification was chosen to improve the presentation of certain items. The comparative previous year figures were changed accordingly. The following changes were made:

- The presentation of historical acquisition and production cost of certain assets (certain asset additions were shown net in 2002. The net amount was now allocated to the respective historical acquisition and production cost).
- The presentation of the composition of the capitalized cost and estimated earnings (elimination of effects from hardware sales from the 2002 figures).
- Presentation of temporary differences on which the computation of deferred taxes is based on (elimination of hardware sales from the 2002 figures and detailed reconciliation of temporary differences from consolidation entries).

Exemptive consolidated financial statements pursuant to Sec. 292a (1) and (2) HGB (German Commercial Code)

The consolidated financial statements of PSI AG as of December 31, 2003 were prepared as **exempting consolidated financial statements in accordance with § 292a HGB in conformity with US GAAP** and on the basis of the German Accounting Standards No. 1 (DRS 1) from the German Standardization Committee (Deutscher Standardisierungsrat DRSC e.V.). The provisions of the German Commercial Code (HGB) and German Stock Corporation Law (AktG) differ from US 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:

According to HGB, all items in the balance sheet and statement of income must follow the form and classification set out in Secs. 266 and 275 HGB. US GAAP requires a different presentation by which the balance sheet items are classified in order of liquidity. Under US GAAP current portions of non-current receivables and liabilities are stated in separate balance sheet items. The portion due within twelve months is considered to be current.

Compared with German accounting principles, the application of US GAAP results in differences in the area of foreign currency valuation, deferred taxes, leases, revenue recognition, capitalization of software development costs, and the calculation of scheduled and extraordinary amortization of goodwill, and accounting for stock option plans.

3. Changes in the consolidated group

Subsidiaries

The following companies are included in the consolidated financial statements as subsidiaries. The information provided in this table is not in accordance with accounting principles generally accepted in the United States of America, but rather in accordance with accounting principles generally accepted in Germany ("HGB").

	Shares %	Equity* as of Dec. 31, 2003 EUR k	Net income* 2003 EUR k
PSI-BT Business Technology for Industries AG, Düsseldorf ("PSI-BT")	58.0	7,202	1,123
PSI UBIS United Business Internet Solutions AG, Berlin ("UBIS")	100.0	730	– 818
PSIPENTA Software Systems GmbH, Berlin ("PSIPENTA")	100.0	– 3,035	– 3,035
PSI Transportation GmbH, Berlin ("Transportation")	100.0	207	– 591
NENTEC Netzwerktechnologie GmbH, Karlsruhe ("Nentec")	100.0	26	0
PK Software Engineering GmbH, Leonberg ("PK Soft")	100.0	454	4
PSI Logistics GmbH, Berlin ("Logistics") – Group	100.0	273	278
PSI AG Produkte und Systeme der Informationstechnologie, Glattzentrum, Switzerland ("PSI/CH")	100.0	56	172
Büsing & Buchwald Gesellschaft für Organisation und Datenverarbeitung mbH, Barsinghausen	100.0	917	281
GSI – Gesellschaft für Steuerungs- und Informationssysteme mbH, Berlin ("GSI")	100.0	65	7
front2back AG, Berlin	100.0	11	– 26

* Values according to statutory GAAP (HGB) prior to consolidation entries

Acquisitions and similar transactions

a) Fiscal year 2003

By virtue of a notarized agreement of March 25, 2003, PSI AG aquired 54 % of GSI – Gesellschaft für Steuerungs- und Informationssysteme mbH. The sales price was paid in cash at an amount of EUR 28k. After the acquisition PSI AG owns 100 % of the shares of GSI. GSI develops software solutions, being used within the product PSIpenta as well as in other Group software solutions.

At April 2003, PSI AG acquired 66 % of the shares of front2back AG. The sales price for the shares of front2back AG was paid in cash at an amount of EUR 33k. After the acquisition PSI AG owns 100 % of the shares of front2back AG. front2back AG offers software solutions for internet applications.

By virtue of a notarized agreement of June 19, 2003, PSI AG aquired 1.1 % of PSI Logistics GmbH. The sales price was paid in cash at an amount of EUR 15.6k. After the acquisition PSI AG owns 100 % of the shares of Logistics. Logistics offers software solutions for the logistic business.

By virtue of a notarized agreement of December 18, 2003, PSI AG aquired 25 % of PK Software Engineering GmbH. The sales price was paid in 2004 in cash at an amount of EUR 300k. After the acquisition PSI AG owns 100 % of the shares of PK Software Engineering GmbH. PK Software Engineering GmbH offers software solutions for public authorities.

Acquisitions in 2003 were carried out to gain 100 % interests in the shares of companies that are integrated in the segments of PSI AG.

b) Fiscal year 2002

At March 26, 2002, PSI AG sold 13,000 shares of front2back AG at a price of EUR 33k. Thus PSI's stake in front2back AG has reduced from 60 % to 34 %.

By virtue of a notarized purchase agreement of April 11, 2002, PSI AG acquired 100 % of the shares in Büsing & Buchwald Gesellschaft für Organisation und Datenverarbeitung mbH. The sales price was paid in cash at an amount of EUR 2,045k and the issuance of 200,000 shares. Additionally it was agreed, that future payments up to a maximum amount of EUR 1,300k will be due, when specific terms such as earnings and PSI's stock price development will be met in the years 2002 to 2004.

By virtue of a notarized agreement of August 27, 2002, PSI Infrastruktur Services GmbH – a 100 %-subsidiary of PSI AG – was merged with Schindler Technik Aktiengesellschaft – an associated company of PSI AG. PSI AG was granted 23,968 shares of Schindler Technik Aktiengesellschaft, with dividend rights from January 1, 2002. Futhermore PSI was granted the right, to buy additional 23,488 shares of Schindler Technik Aktiengesellschaft at a purchase price of EUR 64k in a period of two years. In conjunction with the merger Schindler Technik Aktiengesellschaft increased its share capital by EUR 48k. Due to the merger and the issuance of shares PSI AG's stake in Schindler Technik Aktiengesellschaft increased to 34.7 %. The merger was registrated in the Commercial Register on October 31, 2002.

On December 2, 2002, the insolvency process on PSI Solutions GmbH – a 100 %-subsidiary of PSI AG – was initiated.

c) Summary

For acquisitions in fiscal year 2003, purchase prices totaling EUR 377k (prior year EUR 3,015k) were paid. The fair value of shares issued by PSI as consideration in 2002 was assessed based on market values as of the effective date of the related acquisition.

The following is a preliminary allocation of the purchase prices for the acquisitions to the fair value of the assets acquired and liabilities assumed:

	2003 EUR k	2002 EUR k	Straight-line amortization/ useful life
Intangible assets			
Customer list	0	1,300	10 years
Software and licenses	33	39	3-10 years
Property, plant and equipment	20	235	3-4 years
Goodwill	601	967	
Short-term assets			
Order backlog	0	1,216	
Receivables	283	254	
Other assets	149	392	
Cash and cash equivalents	0	1,227	
Total of assets acquired	**1,086**	**5,630**	
Liabilities			
Accruals	– 228	– 763	
Advance payments	– 24	– 1,366	
Trade payables	– 44	– 74	
Other liabilities	– 413	– 412	
Total of liabilities acquired	**– 709**	**– 2,615**	
Total of purchase prices paid	**377**	**3,015**	

The Goodwill presented above may not be recognized for tax purposes. Of the Goodwill acquired in 2003, EUR 300k and EUR 302k relate to the segments information management and production management, respectively. (Goodwill from acquisitions consummated in 2002 relates entirely to the segment net management.)

The allocation of purchase price is based on estimates of fair value and is subject to revision based upon finalization of management’s assessment of the fair value of net assets acquired.

The results of operations of the acquired entities (GSI and front2back AG) have been included in the consolidated statement of operations since the related acquisition date.

As the net worth, financial position and results of operations of front2back AG and GSI are not material in comparison to the net worth, financial position and results of operations, there is no need to present any pro forma information (equally immaterial in the prior year).

Other transactions
a) Fiscal year 2003
Subsequent to the acquisition of front2back, PSI AG merged the business activities of front2back with PSI UBIS United Business Internet Solutions AG.

b) Fiscal year 2002
By virtue of a notarial deed of August 16, 2002, PSI AG contributed the business shares held in PSIPENTA Automotive GmbH, worth a nominal EUR 10k (40 % of the subscribed capital of PSIPENTA Automotive GmbH), to PSIPENTA Software Systems GmbH at book value. The contribution amount was contributed to the capital reserve of PSIPENTA Software Systems GmbH.

Also by virtue of a notarial deed dated August 16, 2002, PSIPENTA Automotive GmbH was merged with PSIPENTA Software Systems GmbH. Previously, Softsystems Scheufele & Happe GmbH, a wholly owned subsidiary of PSIPENTA Automotive GmbH had been merged with PSIPENTA Automotive GmbH. The mergers had no accounting effects on the consolidated financial statements of PSI AG. The merger of PSIPENTA Automotive GmbH with PSIPENTA Software Systems GmbH was filed with the Commercial Register on November 13, 2002.

4. Costs and estimated earnings in excess of billings on uncompleted contracts

Costs and estimated earnings in excess of billings on uncompleted contracts arise when revenues have been recorded but the amounts cannot be billed under the terms of the contracts. These amounts are realized according to various performance criteria, such as the achievement of specific milestones, the ratio of scheduled to actual project hours of certain employees, the completion of certain units or the completion of the contract. The balance sheet item contains directly allocable direct costs (labor cost and cost of services provided by third parties) as well as the appropriate portion of overheads.

Costs and estimated earnings on uncompleted contracts and related amounts from the application of the percentage of completion methodconsist of the following:

	Dec. 31, 2003 EUR k	Dec. 31, 2002* EUR k
Costs incurred on uncompleted contracts	48,337	29,754
Estimated earnings	9,450	15,257
	57,787	**45,011**
Less received down payments	– 37,959	– 30,408
	19,828	**14,603**

* See note 2 “summary of significant accounting and valuation principles”/ Changes of principles of classification

Such amounts are included in the accompanying consolidated balance sheets under the following captions:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Costs and estimated earnings in excess of billings on uncompleted contracts	31,640	36,723
Billings in excess of costs and estimated earnings on uncompleted contracts	–11,812	–22,120
	19,828	**14,603**

5. Inventories

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Work in progress	1,288	1,771
Hardware and third-party licenses	1,429	1,891
Advance payments to subcontractors	70	0
	2,787	**3,662**

6. Other receivables

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Receivables due from tax authorities	808	1,365
Advance payments	186	225
Other	1,412	1,778
	2,406	**3,368**

7. Financial assets

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Marketable securities	4,122	3,875
Associated companies consolidated “at equity”	749	840
Investments valued at cost	980	1,300
	5,851	**6,015**

The acquisition costs and current selling values of the securities stated at market value shown under financial assets break down as follows:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Marketable securities		
Acquisition cost	4,506	4,258
Unrealized losses	– 384	– 383
Fair value	**4,122**	**3,875**

The marketable securities mainly consist of shares of SZ-Cofonds (investment fund) which invests in German companies listed in the DAX 100 and other European debt securities. Investment income/loss from this investment fund (dividends paid, holding gains/losses) amounts to EUR 196k for 2003 and EUR – 272k for 2002 respectively.

Associated companies accounted for under the equity method comprise the book values of the following companies:

	Share %	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
VA TECH CNI Control Networks & Information Management GmbH	40.0	520	600
Schindler Technik AG	34.7	229	229
front2back AG*	34.0	0	11
		749	**840**

* Outstanding GSI and front2back shares were acquired by PSI AG in 2003. GSI and front2back are accordingly reported as subsidiaries at year end. Refer to footnote 3 “Changes in the consolidation group”

The investments valued at cost compromise the net acquisition cost of Varial Software AG. PSI AG holds an interest of 9.1 % in the company. The initial acquisition cost amount to EUR 1,300k. In fiscal year 2003 a valuation allowance of EUR 320k was recorded.

8. Property, plant and equipment and intangible assets

The development of the property, plant and equipment and intangible assets is shown in the fixed assets movement schedule.

9. Financial liabilities

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Current	5,360	3,540
Non-current	393	522
	5,753	**4,062**

PSI AG has taken out several bank loans with an original face value of EUR 470k (EUR 2,626k in 2002) in total to finance investments in property, plant and equipment and intangible assets. Additionally, several Group companies use bank overdrafts for short-term financing. The loans carry an interest rate of 5.2 % per annum (2002: 5.3 % per annum) and overdrafts carry an average interest rate of 8 % per annum (2002: 8.25 % per annum). Financial liabilities are repaid monthly. The Company intends to refinance its short-term financial liabilities continuously.

The following table shows the planned repayment of non-current financial liabilities and current overdraft facilities:

Year	Repayment EUR k
2004	5,360
2005	393
	5,753

Interest expenses amounted to EUR 637k (2002: EUR 401k).

The current cash position of PSI Group as of December 31, 2003 amounts to KEUR 16,970 (2002: KEUR 21,532). As of balance sheet date the following credit lines are available to PSI Group:

	Guarantees EUR k	Mixed guarantees and credit lines EUR k
Credit lines	49,829	9,375
Usage of credit lines	– 35,117	– 4,039
Remaining credit lines	14,712	5,336

Guarantees are available at interest rates ranging from 1 % per annum to 2.25 % per annum and credit lines at an interest rates ranging from 7.75 % per annum to 9.75 % per annum The above credit lines do not expire.

10. Other current liabilities and other accruals

Other current liabilities and accrued expenses break down as follows:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Accrued project related costs	7,284	5,548
Accruals for personnel costs	5,070	5,770
Liabilities due to tax authorities	2,943	3,543
Liabilities for social security costs	1,415	1,472
Other	3,765	4,772
	20,477	**21,105**

The Company has an early retirement program offered to individual employees. Related costs from these contracts are included in personnel related accruals.

11. Pension accruals

The Company has made pension pledges (unfunded plan) to various employees. These payments are based on the length of service and agreements in the employment contracts. In line with common German practice, the pension plan is not secured by a pension fund. The pension accruals are calculated on the basis of an independent actuarial opinion. The valuation of pension obligations is based on the projected unit credit method in SFAS No. 87 “Employers’ Accounting for Pensions”.

Net pension expenses are composed as follows:

	2003 EUR k	2002 EUR k
Service cost	703	655
Interest cost	1,271	1,229
Actuarial loss	143	135
Effects of curtailment	– 585	0
Expenses for the period, net	**1,532**	**2,019**

The following tables set forth changes in the benefit obligation:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Benefit obligation, beginning	20,525	18,944
Service cost	703	655
Interest cost	1,271	1,229
Actuarial loss	143	135
Effects of curtailment	– 585	0
Benefits paid	– 286	– 266
Amortization of differences	– 37	– 40
Transfers/acquisitions	0	– 132
Benefit obligation, ending	**21,734**	**20,525**

The calculations prepared by an actuary relating to the pension accruals disclose a value of EUR 23,017k for the Projected Benefit Obligation (PBO) for the fiscal year ending on December 31, 2003 (prior year: EUR 23,193k). The difference between the PBO and the benefit obligation results from unrecognized actuarial losses.

To calculate the pension obligations in the fiscal year and the prior year, a discount of 6.5 % and long-term salary increase rates of 1.5 % were assumed.

12. Stockholders' equity

Common stock

The common stock entered in the commercial register, which has been fully paid in, stands at EUR 28,192,947.20 (2002: EUR 28,153,955.11). The capital stock is divided into 11,012,870 (2002: 11,012,870) no-par shares.

At the annual general meeting of the Company on June 12, 2003 the Management Board was authorized to acquire up to approximately 10 % (EUR 2,800,000) of common stock. This authorization expires on December 11, 2004. In 2003, the Company acquired 17,919 shares in several installments for a total purchase price of EUR 73k (2002: 0k). The Company accounts for treasury stock using the cost method and is shown as a reduction of equity.

Capital increases

a) Fiscal year 2003

At the annual general meeting of the Company on June 12, 2003 the shareholders of PSI AG authorized the conversion of EUR 38,992 from other reserves into common stock and reassessed the imputed value of the shares to EUR 2.56 (formerly: EUR 2.55646). The capital increase was filed with the commercial register on September 24, 2003.

b) Fiscal year 2002

By virtue of a notarized purchase agreement of July 11, 2001, 40 % of the shares in PSIPENTA Automotive GmbH, Gelsenkirchen, were acquired by through the issuance of 161,710 no-par shares with an imputed value of EUR 2.56. That increase in capital (EUR 413,405.05) was filed with the commercial register on January 21, 2002.

By share purchase agreement dated June 8, 2001, 21.6 % of the shares in PSI Aktiengesellschaft Produkte und Systeme der Informationstechnologie, Schwerzenbach, Switzerland, were acquired by issue of 19,000 no-par shares with an imputed value of EUR 2.56. The seller of the shares has assigned the right to issue of shares in Gontard & MetallBank AG i.L. for cash payment. The administrator of Gontard & MetallBank i.L. has declared to PSI AG that he waives assumption of the shares for cash payment of an amount equivalent to the current price of the shares. Following this, PSI AG paid an amount of EUR 28,500 to the administrator.

By share purchase agreement certified by public notary dated September 11, 2001, 25 % of the shares in UBIS United Business Internet Solutions AG, Berlin, were acquired by issue of 525,000 no-par shares with an imputed value of EUR 2.56. That increase in capital (EUR 1,342,141.19) was filed with the commercial register on June 20, 2002.

By virtue of a purchase agreement of April 11, 2002, 100 % of the shares in Büsing & Buchwald Gesellschaft für Organisation und Datenverarbeitung mbH were acquired by issuing 200,000 no-par shares with an imputed EUR 2.56 share in capital stock and by payment of EUR 2,045k in cash. That increase in capital (EUR 511,291.88) was filed with the commercial register on November 27, 2002.

Authorized and contingent capital

Authorized and contingent capital amount as following:

	Dec. 31, 2003 EUR	Dec. 31, 2002 EUR
Authorized capital (AC)		
AC I (until June 7, 2006)	2,585,000.00	2,585,000.00
AC II (until June 7, 2006)	4,823,911.07	4,823,911.07
AC III (until May 25, 2005)	1,231,114.15	1,231,114.15
	8,640,025.22	**8,640,025.22**
Contingent capital (CC)		
CC II (May 25, 2005)	1,280,000.00	1,278,229.70
	1,280,000.00	**1,278,229.70**
	9,920,025.22	**9,918,254.92**

The amount of contingent capital has been changed in the course of the above-mentioned capital increase.

Changes in capital and other reserves

The Management Board of PSI AG proposed to offset accumulated losses against capital reserves at an amount of EUR 40.867k in accordance with sec. 150 of the German corporate law.

13. Stock-based compensation

As part of a stock option program, the Company has issued stock options to its employees. The objective of this program is to attract and retain personnel and promote the success of the Company by providing employees the opportunity to acquire common stock.

The Company is authorized to issue 500,000 option rights for the subscription of PSI AG shares to employees of PSI AG and its affiliated companies until May 25, 2005.

Under the 2000/2003 stock option plan (the "2000/2003 plan") the Company has issued 86,400 option rights for the subscription of 86,400 PSI shares to employees of PSI AG. The option rights entitle the bearer to purchase shares in the Company at a price of EUR 24.13 and to vest such shares for the first time after approximately two and a half years. No further conditions have been set up for exercising the option rights.

Under the 2001/2003 stock option plan (the "2001/2003 plan") the Company has issued 121,400 option rights for the subscription of 121,400 PSI shares to employees of PSI AG. The option rights entitle the bearer to purchase shares in the Company at a price of EUR 17.79 and to vest such shares for the first time after approximately two years. No further conditions have been set up for exercising the option rights.

Under the 2002/2004 stock option plan (the "2002/2004 plan") the Company has issued 116,300 option rights for the subscription of 116,300 PSI shares to employees of PSI AG. The option rights entitle the bearer to purchase shares in the Company at a price of EUR 3.65 and to vest such shares for the first time after approximately two years. No further conditions have been set up for exercising the option rights.

The options had no positive intrinsic value at the grant date.

The status of the Company's stock option plans is summarized as follows:

	2000/2003 plan share options	2001/2003 plan share options	2002/2004 plan share options
Options outstanding as of Dec. 31, 2001	**83,450**	**117,800**	**0**
Granted	0	0	116,300
Exercised	0	0	0
Forfeited	– 10,400	– 8,500	– 6,800
Options outstanding as of Dec. 31, 2002	**73,050**	**109,300**	**109,500**
Granted	0	0	0
Exercised	0	0	0
Forfeited	– 73,050	– 109,300	– 1,200
Options outstanding as of Dec. 31, 2003	**0**	**0**	**108,300**

Options outstanding as of Dec. 31, 2003 have an average remaining life of five months. The number of exercisable shares is 0.

According to the calculation contained in SFAS No. 123, the fair value of options granted under the 2000/2003 plan was approximately EUR 3.92 per share. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used: risk free interest rate at 5.29 % per annum, expected life of 32 months, expected dividend yield of zero percent and expected volatility of 15 %.

According to the calculation contained in SFAS No. 123, the fair value of options granted under the 2001/2003 plan was approximately EUR 3.07 per share. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used: risk free interest rate at 4.72 % per annum, expected life of 24 months, expected dividend yield of zero percent and expected volatility of 15 %.

According to the calculation contained in SFAS No. 123, the fair value of options granted under the 2002/2004 plan was approximately EUR 0.85 per share. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used: risk free interest rate at 4.46 % per annum, expected life of 24 months, expected dividend yield of zero percent and expected volatility of 20 %.

14. Obligations from rent and lease agreements and other financial commitments and contingent liabilities

Rental and lease agreements

Office equipment, data processing systems and other equipment have been rented on the basis of operating lease agreements. In 2003 leasing charges of EUR 116k (2002: EUR 142k) was incurred for office equipment and of EUR 799k (2002: EUR 300k) for the rented data processing systems and other equipment.

In fiscal year 1996 PSI AG entered into a rent agreement for an office building in Berlin. The rent agreement expires on March 31, 2012. Furthermore, PSIPENTA entered into a rent agreement for a further office building in Berlin in fiscal year 1999.

The rent agreements mentioned above as well as further rent and lease agreements give rise to the following rent and lease payments:

	Rental payments EUR k	Lease payments EUR k	Total EUR k
2004	4,648	702	5,350
2005	3,893	536	4,429
2006	3,164	356	3,520
2007	2,764	25	2,789
2008	2,345	13	2,358
2009 and thereafter	6,838	0	6,838

Bank securities

Various insurance companies and banks has assumed bank securities for EUR 35,117k (2002: EUR 38,260k) for PSI.

Subordination and Comfort Letter

PSI AG declared subordination for certain receivables due from subsidiaries in the amount of EUR 4,926k. In addition, comfort letters were issued for subsidiaries (partly with finite lives).

Existing legal disputes

PSI AG is involved in a legal disputes which bears risks that have a potential negative impact on earnings of EUR 3.6 million, but no cash effect. No provision was recognized because a decision in favour of PSI AG is expected.

Tax field audit

In fiscal year 2002, a tax field audit was finished for several companies of the PSI Group for fiscal years 1996 through 2000. The results of the tax field audit – apart from issues that are currently still pending in terms of principle before the fiscal courts (approx. volume EUR 300k) – have been considered in the consolidated financial statements.

15. Income taxes

	2003 EUR k	2002 EUR k
Current income tax expense	– 1,040	– 102
Deferred tax income	417	4,175
	– 623	**4,073**

A reconciliation of income taxes determined using the combined statutory rate of 40.2 % (2002: 38.9 %) is as follows:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Loss before income taxes	– 1,548	– 18,965
Expected benefit for income taxes	622	7.376
Utilization of tax loss carryforward	1,905	551
Impairment of goodwill	0	– 2,098
Valuation allowance on deferred tax assets	– 3,129	– 601
Other items	– 21	– 1,155
	– 623	**4,073**

Valuation allowances on deferred tax assets were considered if it is not more likely than not that the related tax loss carryforwards will be used in the future.

Deferred tax assets and liabilities are summarized as follows:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Short-term portion of tax liabilities (net):		
Deferred tax assets resulting from tax loss carryforwards	31,948	31,999
Valuation allowance for deferred tax assets resulting from tax loss carryforwards	– 27,643	– 26,284
Deferred tax assets (net)	4,305	5,715
Deferred tax liabilities resulting from the application of the percentage-of-completion method	– 3,799	– 5,935
Others	– 185	– 207
	321	**– 427**
Long-term portion of tax liabilities (net):		
Capitalized software development costs	– 975	– 714
Pension accruals	367	39
Deferred tax liabilities resulting from goodwill amortization (tax deductable)	– 416	– 41
Deferred tax liabilities resulting from early retirement contracts with employees	– 236	0
Others	260	209
	– 1,000	**– 507**
Net deferred tax liabilities (net)	**– 679**	**– 934**

The deferred tax liabilities (net) include additions resulting from the first time inclusion of subsidiaries in the consolidated financial statements of PSI Group at the amount of EUR 162k (net liabilities).

The deferred tax asset (before valuation allowances) resulting from tax loss carryforwards (unlimited) developed as follows:

	Dec. 31, 2003 EUR k	Dec. 31, 2002 EUR k
Tax loss carryforwards (beginning of period)	31,999	29,072
Tax losses current period	1,779	3,478
Utilization of tax loss carryforwards	– 1,905	– 551
Changes in the PSI Group structure	174	0
Changes due to tax field audit and tax rate changes	– 99	0
	31,948	**31,999**

16. Segment reporting

Segment reporting for network management, production management and information management was done on the basis of the statements of income for the Group companies included in comprehensive consolidation. The income statements were adjusted to eliminate intra-group effects.

The “network management” segment mainly comprises the business activities of the Energy, Gas/Oil/Water and Telecommunications divisions (of PSI AG), Büsing & Buchwald GmbH, PSI Transportation GmbH and Nentec GmbH, which mainly involve the creation, introduction, service and maintenance of customer-specific software in the energy, oil, gas, water, telecommunications and public transport spheres. In the fiscal year, there were no sales in which a single customer achieved a sales volume of more than 10 % of total sales for the segment.

The “production management” segment mainly comprises the business activities of PSI-BT AG, with solutions for the steel and chemicals industries, PSI Logistics GmbH, with products and solutions for warehouse logistics, and PSIPENTA with products, and increasingly also solutions, for the manufacturing industry. PSI AG/Switzerland and PSI AG/UK exclusively sell the portfolio of PSI AG in these regions. In Austria and the Netherlands, the product portfolio of PSIPENTA GmbH is sold. In 2003, a new division of PSI AG was founded (PSI Manufacturing). The new division is in a start-up phase. The division and the acquired affiliate GSI have been added to the segment production. In 2003, there were no sales to a single customer of more than 10 % of total sales for the segment.

The “information management” segment mainly comprises the business activities of the public management division (of PSI AG), of PK Software Engineering GmbH and of PSI UBIS AG. The information management division mainly sells software solutions to public authorities. In 2003, there were no sales to a single customer of more than 10 % of total sales for the segment.

For segment reporting, please refer to page 38.

Segment reporting – sales by geographically defined area

The following table provides geographical information in respect of sales (sales to domestic customers and sales to international customers):

	Germany		Other countries		Total	
	2003	2002	2003	2002	2003	2002
	EUR k	EUR k	EUR k	EUR k	EUR k	EUR k
Software production and maintenance	101,514	101,904	15,673	20,785	117,187	122,689
Licenses	4,204	5,457	1,088	1,961	5,292	7,418
Hardware	13,024	19,708	2,149	900	15,173	20,608
	118,742	**127,069**	**18,910**	**23,646**	**137,652**	**150,715**

17. Reorganization and restructuring expense

In fiscal year 2003, various reorganization and restructuring measures were carried out. These measures, which are intended to reduce operative expenses and sales costs in following years significantly, led to expenses in the amount of EUR 2,413k (prior year: EUR 8,730k). The reorganization and restructuring measures mainly applied to the production and information management segments and to the corporate departments whose costs are allocated to all segments.

18. Corporate Governance

PSI AG has declared its compliance with the recommendations of the German Corporate Governance Code pursuant to Sec. 161 AktG and Sec. 15 EGAktG. Shareholders can access this declaration of compliance at all times.

19. Major shareholders

In fiscal year 2003, a consortium, in which various employees of PSI AG combined their shares for the purpose of voting in common, issued an updated report pursuant to Sec. 21 WpHG, stating that the consortium holds 7.1 % of the voting rights in PSI AG. An investment company informed about holding 5.14 % of the voting rights in the Company in accordance with Sec. 21 WpHG. There were no other reports pursuant to Sec. 21 WpHG or Sec. 20 AktG.

20. Subsequent events

In February 2004, PSI UBIS United Business Internet Solutions AG, Berlin, has been transformed to PSI Information Management GmbH. The Segment Public Management will be integrated in PSI Information Management GmbH. All shares in the company are held by PSI AG.

21. Cash Flow Statement

The short-term financial liabilities for the purpose of project financing are shown in the cash flow statement under short-term operational financial liabilities.

22. Supplementary declarations pursuant to HGB

The following information comprises supplementary declarations that are a mandatory part of the explanatory notes pursuant to HGB:

Remuneration of the management board and supervisory board
In fiscal year 2003, the management board of PSI AG received remuneration of EUR 387k (2002: EUR 1,240k). For former members of the management board pensions reserves amounting to EUR 808k has been considered. The supervisory board received remuneration amounting to EUR 73k (2002: EUR 115k).

The following persons were members of the **management board** in 2003:

Members of the management board

Name	Profession	City	Member since
Armin Stein	Graduate Businessman/ Graduate engineer (FH)	Berlin	January 1, 2001
Dr Harald Schrimpf	Graduate engineer	Berlin	July 8, 2002

The following persons were members of the **supervisory board** in 2003:

Members of the supervisory board

Name/period of the office	Profession	City	Membership in other supervisory boards of listed companies
Christian Brunke (Chairman) Since June 7, 2002	Business economics graduate	Berlin	
Wolfgang Dedner (Deputy chairman) Since June 7, 2002	Graduate engineer	Berlin	
Klaus Linke Since June 7, 2002	Graduate engineer	Werne	
Karsten Trippel Since June 7, 2002	Businessman	Großbottwar	Berlina AG für Anlagewerte Ost-West Beteiligungs- und Grundstücksverwaltungs AG
Dirk Noß (Employee representative) Since June 12, 2003	Graduate engineer	Aschaffenburg	
Barbara Simon (Employee representative) Since June 12, 2003	Graduate engineer	Berlin	
Wolfgang Fischer (Employee representative) Until June 12, 2003	Graduate engineer (FH)	Aschaffenburg	
Siegfried Hartmann (Employee representative) Until June 12, 2003	Graduate engineer	Aschaffenburg	

Number of employees

During the year ended December 31, 2003, the PSI Group employed an average of 1,221 people (2002: 1,338).

Material and personnel expenses

	2003 EUR k	2002 EUR k
Cost of materials		
Purchased merchandise and services	27,469	40,412
	27,469	**40,412**
Personnel expenses		
Wages and salaries	70,567	80,319
Social security and pensions	12,336	12,626
	82,903	**92,945**

Proposal for the appropriation of earnings

The management board proposes to retain the statutory profit for the year ended December 31, 2003 and to settle the accumulated losses in the amount of EUR 40.867k via a transfer from the capital reserves account.

	EUR
Accumulated loss	– 44,562,459.64
Group net loss of the year	3,696,069.15
Subtotal	– 40,866,390.49
Reduction of the additional paid-in capital	40,866,390.49
Accumulated statutory loss	**0.00**

Berlin, February 25, 2004

Dr Harald Schrimpf
Board of Directors

Armin Stein
Board of Directors

Auditor's Report for the exempting consolidated financial statements in accordance with § 292a HGB

We have audited the consolidated financial statements of PSI Aktiengesellschaft für Produkte und Systeme der Informationstechnologie, Berlin, from January 1, 2003 to December 31, 2003, including the consolidated balance sheet and the related consolidated statement of income, cash flows, changes in shareholders' equity and notes for the year then ended. The legal representatives of the Company are responsible for the preparation and content of the consolidated financial statements. Our responsibility is to express an opinion, based on our audit, whether these consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (US GAAP).

We conducted our audit in accordance with the German Auditing Rules and in compliance with the general accepted standards of auditing prescribed by the German Institute of Certified Public Accountants (Institut der Wirtschaftsprüfer). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatements. In establishing the audit procedures we considered our knowledge about the Group's business operations, its economic and legal environment, and expectations of possible errors. An audit includes examining the effectiveness of the internal accounting control system, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. The audit also includes assessing the accounting principles used and significant estimates made by the legal representatives, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements present a true and fair view of the Group's net assets, financial position and results of operations in accordance with United States generally accepted accounting principles.

Our audit which also includes the management report for the fiscal period from January 1, 2003 to December 31, 2003 which is the responsibility of the Company's management has not given rise to any reservations. In our opinion the management report and the additional disclosures in the consolidated financial statements conveys a suitable presentation of the situation of the PSI Group taken as a whole and presents the risks to its future developments adequately. Additionally, we confirm that the consolidated financial statements and the Group's management report for the fiscal period from January 1, 2003 to December 31, 2003 meet the requirements for an exemption to prepare consolidated financial statements and the Group's management report in accordance with the rules and regulations of the German Commercial Code.

Ernst & Young AG • Wirtschaftsprüfungsgesellschaft

Selter (Wirtschaftsprüfer) Glöckner (Wirtschaftsprüfer)

Berlin, February 27, 2004

PSI: high-tech stocks with a solid core business and excellent prospects

Investor Relations: Financial Calendar 2004

Annual Results	03-17-2004
DVFA Analyst Conference	03-17-2004
Publication Q1 Report	05-04-2004
Annual General Meeting	05-27-2004
Publication Q2 Report	08-03-2004
Publication Q3 Report	11-02-2004

PSI Stocks

Market Segment:	Prime Standard
SE symbol:	PSA2
German Securities Code (WKN):	696822
ISIN:	DE0006968225

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