

## **Summary of significant differences between International Financial Reporting Standards (IFRS) and accounting principles generally accepted in the United States of America (US GAAP)**

Starting 2005, all companies publicly traded on a regulated market in the European Union ("EU") are required to prepare their consolidated financial statements in accordance with International Financial Reporting Standards ("IFRS")

There are differences between IFRS and US GAAP (herein referred to as "GAAP differences"), certain of which may be significant to the financial information presented. The following is a summary of certain significant GAAP differences between IFRS and US GAAP. This summary does not describe all of the GAAP differences between IFRS and US GAAP, which may be significant for the preparation of the company's consolidated financial statements.

The discussion below primarily focuses on GAAP differences in recognition and measurement requirements affecting the balance sheet and the income statement. Consequently, this summary does not describe GAAP differences related to statement of cash flows, statement of equity, comprehensive income, and presentation and disclosure requirements.

For the purpose of this summary, the GAAP differences described are differences that exist during 2005. IFRS and US GAAP have moved towards convergence in their accounting principles in recent years. Accordingly, additional GAAP differences that existed prior to 2005 are not described below. Also, as accounting rules are further developed or changed over time, additional GAAP differences may arise in the future.

Potential investors should consult with their own professional advisors for an understanding of the GAAP differences and how those differences might affect the financial information prepared under US GAAP included in the listing prospectus of EpiCept.

### **Conceptual differences**

US GAAP is more "rule-based" and gives more rigorous detailed guidance while IFRS provides more principle based standards with limited application guidance.

### **Development stage companies**

According to US GAAP, a development stage company is an entity devoting substantially all of its efforts to establishing a new business and either its planned principal operations have not commenced or its planned principal operations have commenced but have not yet generated significant revenues.

US GAAP has specific additional requirements about the contents and presentation of the financial statements of development stage companies. IFRS has no specific requirements for this kind of companies.

### **Business acquisitions**

Under IFRS, a business combination is defined as "the bringing together of separate entities or businesses into one reporting entity". All business combinations meeting the definition in IFRS 3 must be accounted for by applying the purchase method. Under the purchase method the acquirer shall, at the acquisition date, allocate the cost of a business combination by recognizing the acquiree's identifiable assets, liabilities and contingent liabilities at their fair value at the date of transaction. Goodwill is recognized as the difference between the cost of the business combination and the fair value of the assets, liabilities and contingent liabilities assumed. Intangible assets that do not meet the contractual-legal or separability criteria cannot be recognized as assets.

US GAAP is similar to IFRS with respect to accounting for business combinations, i.e. recognizing assets, liabilities and contingent liabilities assumed in a business combination at fair value. However, under US GAAP, certain business combinations may be accounted for as so-called asset purchases. In such cases, the assets and liabilities of the acquiree are recorded as of the acquisition date at their estimated fair values and recognition of goodwill is prohibited. Also, when applying the asset acquisition rules under US GAAP certain intangible assets that do not meet the contractual-legal or separability criteria could be recognized as assets such as, for example an assembled workforce. An assembled workforce recognized may be amortized over its estimated useful life.

Under IFRS, acquired patented technology (IPR&D) would be capitalized separately from goodwill as an intangible asset and amortized over its useful life. U.S. GAAP also requires separate recognition from goodwill as an intangible asset but requires it to be expensed immediately as a period cost.

### **Date on which consideration in a business combination is measured**

Under IFRS the consideration in a business combination is measured at the date of acquisition, i.e. the date when the acquirer obtains control over the acquiree. Under US GAAP the consideration in a business combination is

measured within a reasonable time frame before and after the date the terms of the acquisition was agreed and announced.

### **Revenue Recognition**

For revenue arrangements with multiple deliverables (those which include the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time), US GAAP provides specific criteria to determine when to recognize up-front fees, research fees and milestone payments. US GAAP also provides specific criteria to determine when deliverables should be accounted for separately and how to allocate the total revenue under the arrangement to those deliverables. IFRS is similar to US GAAP but is not prescriptive as to when to recognize revenue based on the arrangement as a whole compared to applying separate revenue recognition criteria to the individual deliverables.

### **Goodwill and Other Intangible Assets Acquired**

Under IFRS, goodwill is not amortized but is tested for impairment annually, or more frequently if events or circumstances indicate that the asset might be impaired. Additionally, under IFRS, certain intangible assets, usually acquired in a business combination, may have an indefinite useful life. Consequently, under IFRS those intangible assets are not amortized but instead tested for impairment annually or more frequent if events or circumstances indicate that the asset may be impaired.

US GAAP is similar to IFRS as described above except that the annual impairment test for goodwill is required to be performed in a two-step test, at the reporting unit level, compared to the one-step test performed under IFRS. In the first step, the fair value of the reporting unit is compared to the carrying value of the reporting unit including goodwill. If the carrying value of the reporting unit including goodwill exceeds the fair value of the reporting unit, then the second step must be performed requiring that an impairment be measured, and recorded, as the excess of recorded goodwill over the implied fair value of goodwill. The implied fair value of goodwill is calculated by allocating the fair value of the reporting unit to the assets and liabilities of the reporting unit.

### **Property, plant and equipment**

Capitalization of borrowing costs related to assets that take a substantial time to complete is an available, but not mandatory, accounting policy under IFRS. US GAAP requires capitalization of borrowing costs as part of the cost of the asset during the asset construction period.

IFRS requires that a review for the possible impairment of long-lived assets be performed when events or changes in circumstances indicate possible impairment. An impairment is recorded equal to the excess of the carrying amount of the asset over its recoverable amount. An asset's recoverable amount is the greater of the asset's fair value, less costs to sell, or the asset's value in use, which is generally determined based on the discounted estimated future cash flows from the use of the asset. An impairment loss recognised for an asset in prior years is reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset is increased to its recoverable amount not exceeding the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

Under US GAAP, a long-lived asset is deemed to be "held for sale" if certain criteria are met. Otherwise, a long-lived asset is deemed to be "held and used" in the ongoing operations.

Under US GAAP, a long-lived asset which is classified as "held and used" is tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss is recognized only if the carrying amount of the asset is not recoverable and exceeds its fair value. The carrying amount of the asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. The impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value. Fair value is generally measured using discounted cash flows. Subsequent restoration of a recognized impairment loss is prohibited.

## **Leases**

Under US GAAP, a lease is accounted for as a capital lease (financing lease) by the lessee if the lease satisfies one or more of the following criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains an option to purchase the leased property at a bargain price.
- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
- The present value of rental and other minimum lease payments equals or exceeds 90 percent of the fair value of the leased property less any investment tax credit retained by the lessor.

Under US GAAP, if none of the above criteria are met, the lessee accounts for the lease as an operating lease. In addition, US GAAP includes further prescriptive guidance on applying those above criteria to certain facts and circumstances which are largely based on the form of the contract.

Under IFRS, a lease is classified as a financing lease by the lessee if it transfers substantially all the risks and rewards incident to ownership to the lessee. A lease is classified as an operating lease by the lessee if it does not transfer substantially all the risks and rewards incident to ownership to the lessee. Under IFRS, whether a lease is a financing lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Accordingly, IFRS is less prescriptive than US GAAP and can result in differences in accounting for leases and sale leaseback transactions.

### **Research and Development Costs**

Under IFRS, product research costs are expensed as incurred whereas product development costs are capitalized if the company can demonstrate that (a) it has the technical feasibility to complete the product development such that it will be available for sale, (b) it has the intention to complete the asset and it has the ability to use or sell it, (c) the asset will generate probable future economic benefits, (d) adequate technical, financial and other resources are available to complete the development, and (e) it has the ability to reliably measure the expenditure attributable to the intangible asset during its development. Under US GAAP, research and development costs related to products are expensed as incurred.

Under US GAAP, certain development costs for software for internal use are required to be capitalized as an intangible asset and are amortized to expense over their estimated useful life. While internal use software development costs may also be capitalized under IFRS, US GAAP is more prescriptive in its requirements to also capitalize certain direct internal costs in addition to direct external costs.

### **Deferred Income Taxes**

Under IFRS, deferred income tax assets carried forward are recognized to the extent that it is probable that future taxable income will be available against which the unused income tax losses can be utilised. Deferred income tax assets and liabilities are measured based on tax rates enacted or substantively enacted as of the balance sheet date.

Under US GAAP, deferred income tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the

amount that is more likely than not to be realized. Deferred income tax assets and liabilities are measured based on tax rates enacted as of the balance sheet date.

### **Stock Options Granted to Employees and related Payroll Taxes**

Under IFRS, stock options generally are valued at fair value at the grant date and recognized as an expense in the income statement over the vesting period, after adjustment for the number of options expected to vest.

Under US GAAP, share options should also be recognized as an expense in the income statement. However, up to and including 2005, US GAAP allowed two different methods for the valuation of the options: the intrinsic value method and the fair value method. Under the intrinsic value method, the expense recorded for each option is the difference between the strike price of the options and the market value of the stock at the date of the closing. Effective from 2006, the intrinsic value option will no longer be available.

Any amounts paid by the employees at the time of exercising the stock options to acquire newly issued shares of the company are recorded as additional equity at that time.

Under US GAAP, payroll taxes related to stock options granted to employees should generally be recognized only on exercise of the options. IFRS has no specific rules concerning payroll taxes in connection with stock options granted to employees.

### **Reclassification of Liabilities**

Some borrowing agreements incorporate undertakings by the borrower (covenants) under which the liability becomes payable on demand if certain conditions related to the borrower's financial position are breached. Under IFRS, such liability is classified as current even if the lender has agreed, after the balance sheet date and before the authorization of the financial statements for issue, not to demand repayment. The liability is classified as current because, at the balance sheet date, the company does not have an unconditional right to defer its settlement for at least twelve months after that date.

According to US GAAP, such liabilities are classified as non-current if the lender has agreed, prior to the authorization of the financial statements for issue, not to demand repayment for more than one year from the balance sheet date and it is not possible that further breaches will occur within twelve months of the balance sheet date.

## **Derivative Financial Instruments**

IFRS and US GAAP require that all derivative instruments, whether free-standing or embedded in non-derivative contracts, be recorded on the balance sheet as either an asset or liability measured at fair value. Changes in the fair values during a reporting period are recognized currently in earnings, unless specific hedge accounting criteria are met regardless of management's intent to use the derivatives as hedges. For cash flow hedges and net investment hedges qualifying for hedge accounting, changes in the fair value of the derivative instrument are recognized directly in equity. As both US GAAP and IFRS are very prescriptive in regards to the accounting for derivative financial instruments, there are some minor differences related to specific facts and circumstances not encompassed in this discussion.

## **Classification of Convertible Debt and Debt with Detachable Share Warrants**

Under IFRS, a company must present the liability and equity components separately on its balance sheet, regardless of whether the debt has a conversion feature or detachable stock warrants. The equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.

Under US GAAP, convertible debt is classified as debt until such time that it is converted into shares, unless the debt includes stock warrants which are detachable from the debt in which case US GAAP would be similar to IFRS, except that the allocation between the liability and equity components would be based on the relative fair values of the two components.

## **Restructuring**

Under IFRS, a provision for restructuring, not associated with a business acquisition, is recognized only when a company has a present obligation as a result of having established a detailed plan regarding the restructuring activities and has raised a valid expectation in those affected by the plan that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both necessarily entailed by the restructuring and not associated with the ongoing activities of the enterprise.

US GAAP requires that restructuring costs not associated with a business acquisition be measured at fair value and be recorded in the period in which the liability is incurred rather than at the date of a commitment to a plan by management. For involuntary employee termination benefits, if employees are

not required to render service until they are terminated in order to receive the termination benefits or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits is recognized and measured at its fair value at the date that the plan is communicated to the employees. If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, the liability for the termination benefits is measured initially at the communication date, based on the fair value of the liability as of the termination date, and then recognized ratably over the future service period. A liability for costs to terminate a contract before the end of its term is recognized and measured at its fair value when the entity terminates the contract. A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity is recognized and measured at its fair value when the entity ceases using the right conveyed by the contract. A liability for other costs of a restructuring plan is recognized and measured at its fair value in the period in which the liability is incurred (generally, when goods or services associated with the activity are received). The liability is not recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan.