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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 April 2007, London**
Project:	**Business Combinations II**
Subject:	**Comparison of fair value measurements in IFRSs and US GAAP (Agenda Paper 2A)**

INTRODUCTION

1 During the October 2006 joint meeting, the FASB and the IASB discussed the measurement attribute for business combinations given the different definitions of fair value in IFRSs and US GAAP. IFRSs generally define fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. US GAAP (FASB Statement No. 157, *Fair Value Measurements*) defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

2 In that meeting, the IASB affirmed that fair value is the measurement attribute in a business combination and tentatively decided to use the definition of fair value that is currently in IFRS 3 *Business Combinations*. The FASB deferred deciding that fair value, as defined in Statement 157, is the measurement attribute in a business combination until it could get a better understanding of the potential differences in fair value if there were to be two definitions. The

boards therefore asked the staff to investigate whether the different definitions of fair value might result in different valuations of assets acquired and liabilities assumed in a business combination depending on whether it is accounted for in accordance with IFRSs or US GAAP.

3 To make that determination, the staff organised a working group comprising representatives of the valuation and appraisal community with experience in both IFRSs and US GAAP. Each member of the working group was asked to complete a 'case study' (the case study is shown in Attachment 1) in which they were asked to compare and contrast (both quantitatively and qualitatively) the valuation methodologies, techniques and inputs used to measure the fair values of assets acquired and liabilities assumed in a business combination as if the analysis was being performed under both IFRSs and US GAAP. Although the quantitative results were not part of the objective of the case study, they aided the participants in identifying, qualitatively, potential differences between IFRSs and US GAAP in the fair value of assets acquired and liabilities assumed. The participants worked independently and each submitted a response representing their view.

4 For the valuation under IFRSs, the participants were instructed to use the fair value definition and measurement guidance currently in IFRSs. However, they were instructed to disregard the guidance in paragraph B16 of the current IFRS 3 as this guidance is often inconsistent with the fair value measurement objective. For the valuation under US GAAP, the participants were instructed to use the fair value definition and measurements guidance in Statement 157. They were also instructed to ignore the measurement guidance currently in FASB Statement No. 141, *Business Combinations,* and its related pronouncements.[1]

SUMMARY OF KEY FINDINGS

5 **Participants agreed that the fair value measurement concepts in a business combination were generally consistent between IFRSs and US**

[1] Please note—the responses submitted by the participants represent their own views and do not necessarily represent the views of their firms. Furthermore, the views of the participants are evolving and are based on their current understanding of how Statement 157 will be applied in practice. Accordingly, their views might change after Statement 157 becomes effective and practice evolves and develops further.

GAAP. The respondents concluded that fair value under both IFRSs and US GAAP reflects market participant expectations, which might differ from the entity's own intentions and expectations of the asset or liability. In this regard, some participants noted that Statement 157's explicit reference to market participants brings practice under US GAAP in line with current practice under IFRSs. Respondents also concluded they would use the same models, sources of information, valuation approaches and methodologies under IFRSs and US GAAP. Respondents confirmed that in most situations, except as discussed below, the fair value of an asset or a liability that was appropriate for IFRSs would also be appropriate for US GAAP and vice versa.[2]

6 **Participants identified areas in which GAAP differences might occur, depending on the facts and circumstances of the asset or liability.** Some respondents commented that the following might result in differences in fair value:

a when an asset is acquired in a business combination for defensive purposes and market participants would similarly lock up the asset and that use would maximise the value of the group of assets in which asset is used (for example, brands or IPR&D projects) (paragraph 11);

b potential differences in the settlement definition of fair value for liabilities under IFRSs and the transfer definition under US GAAP (paragraph 12);

c references to different markets under IFRSs and US GAAP, particularly with regard to Level 3-type financial instruments (paragraphs 13-15);

d differences in the application of highest and best use concepts (paragraphs 16-18); and

e differences in guidance regarding non-performance risk and credit standing (paragraphs 19-21).

[2] However, some respondents cautioned against misinterpreting the responses in the case study to be an indication of consensus in valuation practice. These respondents observed that accepted valuation practices and judgements can (and often do) lead to significant differences in fair value measurements for the same asset under the same facts and circumstances.

7 This paper is organised as follows:

a an analysis of case study responses;

b a summary of the possible GAAP differences; and

c a staff recommendation on the definitions of fair value for the final business combinations standard and suggested wording for the basis for conclusions.

8 As discussed in more detail below, the staff recommends the IASB carry forward the definition of fair value currently in IFRS 3 and the FASB use the definition of fair value in Statement 157. The staff also recommends the basis of conclusions emphasise that, while the boards have used different wording to describe similar concepts, the boards are of the view that the following are convergent:

a the requirement to reflect non-performance risk in the fair value of a liability under Statement 157 and the requirement to reflect the credit standing in the fair value of a liability under IAS 39 *Financial Instruments: Recognition and Measurement*.

b the concepts of market participants under Statement 157 and ‘knowledgeable, willing parties in an arm’s length transaction’ in IFRSs (as described in IAS 40 *Investment Property*). In other words, both are market-based measures.

ANALYSIS OF CASE STUDY RESPONSES

9 Respondents identified circumstances in which they believe differences between IFRSs and US GAAP might result in differences in the fair values of assets acquired and liabilities assumed in a business combination. The staff has categorised these possible differences as follows:

a Differences due to the exit price versus exchange amount in the definitions of fair value in Statement 157 and IFRSs, respectively b Differences due to different reference markets under IFRSs and US GAAP

c Possible differences in the application of the concept of 'highest and best use'

d Possible differences in non-performance risk under IFRSs and US GAAP

Differences due to the exit price versus exchange amount

10 Statement 157 defines fair value as an exit price between market participants whereas IFRSs define fair value as an exchange amount between knowledgeable, willing parties in an arm's length transaction. Most respondents discussed the differences in the definitions of fair value in their responses and concluded that, because transaction costs are not a component of the fair value measurement under either framework, an exit price value for an asset or liability acquired or assumed in a business combination would differ from an exchange price (entry or exit) only (a) if the asset is acquired for its defensive value or (b) if a liability will be settled rather than transferred to a third party.

11 Entities might acquire assets (and businesses) for defensive purposes. Such assets might include brands, IPR&D projects or other assets that provide protection from competition. Statement 157 indicates that if market participants would maximise the value of an asset (considering its highest and best use) by similarly using the asset for its defensive value, the asset's fair value should reflect the price that would be received in a current transaction to sell the asset, assuming it would be used with its complementary assets for defensive purposes. Based on responses from the working group members, the staff understands that methods of measuring an asset's 'defensive value' are still developing as a result of Statement 157 (in particular paragraph A12). This implies that the concept of 'defensive value' is not currently employed under IFRSs. As such, 'defensive value' measurements might not develop under IFRSs as they will under US GAAP given the lack of guidance in current IFRSs.

12 Respondents also pointed to differences in the definitions of the fair value of liabilities. Statement 157 indicates the fair value of a liability is the price that a market participant would pay to *transfer* the liability whereas IFRSs refer to a current *settlement* amount. Respondents pointed to the existing guidance in paragraph B16 of IFRS 3 and indicated that this guidance reflects how a preparer might approach the valuation of a liability with a settlement definition, even if this guidance is not carried forward to the revised business combinations standards. Preparers might approach a transfer objective differently, possibly leading to different values for liabilities under IFRSs than under US GAAP. However, the staff observed that respondents used the same approaches to valuing the financial and non-financial liabilities under IFRS and US GAAP in the case study. As such, the difference in wording might not always lead to GAAP differences.

Differences due to different reference markets under IFRSs and US GAAP

13 Statement 157 indicates that a fair value measurement assumes that the transaction to sell an asset or transfer a liability is based on the principal market for an asset or a liability. If there isn't a principal market, fair value should assume that the transaction to sell an asset or transfer a liability is based on the most advantageous market. The principal or most advantageous market is determined from the perspective of the reporting entity (the acquirer). In contrast, IFRSs generally indicate that fair value should be based on the most advantageous market (with some variations between standards).

14 Many respondents indicated that these differences might, in some circumstances, result in differences in fair value under IFRSs and US GAAP. For example, some participants observed that, although it is likely to be infrequent, it is possible that the most advantageous market and the principal market for an asset or liability will not be the same. In such cases, an entity might refer to the most advantageous market under IFRSs and the principal market under US GAAP, resulting in a valuation difference.

15 Although respondents agreed that occurrences of the above situation would be rare in most business combinations, they think that it might occur more often

when financial institutions are involved. Some respondents said that differences between US GAAP and IFRSs in guidance on the principal or most advantageous market, coupled with differences in guidance on measuring the fair value of financial instruments with significant unobservable inputs, would likely lead to substantial differences in fair value for business combinations involving financial institutions.

Differences due to the 'highest and best use' concept in SFAS 157

16 Many respondents stated that the concept of 'highest and best use', which is explicit in Statement 157 and not discussed in IFRSs, could result in differences in fair value measurements. Additionally, respondents observed that if the fair value of, for example, property, plant and equipment were different between US GAAP and IFRSs, there could be a carry-over effect on the fair value of the intangible assets of the acquired business (if valued using an excess earnings approach) because of the contributory asset charges used in the valuation of those intangible assets.

17 Respondents commented that the concepts of highest and best use articulated in Statement 157 were commonly used in appraisal practice prior to the publication of Statement 157. As such, these concepts are currently used under IFRSs, even though IFRSs contain no explicit guidance on them. However, because the concepts are not explicit in IFRSs they might not be applied consistently. Statement 157 articulates the concept that highest and best use reflects the use of an asset that maximises the value of a group of assets in which that individual asset is used (as illustrated in Example 1 in the Implementation Guidance of Statement 157). Respondents identified two ways in which the lack of guidance in IFRSs might lead to different conclusions regarding the highest and best use of an asset acquired in a business combination.

a Although IFRSs do not have explicit guidance on highest and best use, some respondents observed that there is a general presumption that a business is a going concern and that the current configuration of a group of assets reflects the group's highest and best use. However, Statement 157 will encourage the valuation profession to consider alternative uses that might increase the value of the asset group. Some respondents observed that entities might not consider alternative uses for assets under IFRSs as extensively as they would under US GAAP. As a result, they concluded that an entity might value an asset under IFRSs considering its current use in the business whereas it might value the same asset considering an alternative use under US GAAP. This would likely result in a lower value for the asset under IFRSs than under US GAAP.

b One respondent observed that the definition of fair value in IFRSs relates to the fair value of *an asset* [emphasis added]. A literal reading of this definition might cause entities not to consider the use that maximises the value of a group of assets, but only the use that maximises the value of an individual asset in isolation. Under Statement 157, however, an entity would consider the highest and best use of an asset with regard to the group of assets in which that asset is situated. This might cause an entity to conclude that the fair value of an asset under IFRSs should reflect the highest and best use of an individual asset, even if that use of the asset is inconsistent with the highest and best use of the group in which that asset is situated. Conversely, the entity might conclude under US GAAP that the fair value should reflect the asset's current use within the group if that reflects the highest and best use of the group in which the asset is situated. This would likely result in a lower value for the asset under US GAAP than under IFRSs.

18 Valuation and appraisal practices under IFRSs include the concept of highest and best use. As such, the staff thinks that valuations and appraisals under IFRSs will often apply principles consistent with Statement 157. However, respondents also observed, and the staff agrees, that without clear and consistent guidance under IFRSs the concept of highest and best use might not be consistently interpreted or applied. This might result in greater variation in valuations prepared in accordance with IFRSs than might be the case if there were more guidance. Put another way, there might be less variation in a

valuation performed in accordance with Statement 157 and the variability in practice under IFRSs might lead to GAAP differences.

Differences in non-performance risk under IFRSs and US GAAP

19 Some respondents commented that differences in how non-performance risk is reflected in the fair value of liabilities under IFRSs and US GAAP might affect the fair value of the liabilities assumed in a business combination. Statement 157 requires that the fair value of a liability reflect its non-performance risk, which includes the credit standing of the entity. Statement 157 states that the effect of non-performance risk on the fair value of a liability will differ depending on the terms of the liability and its related credit enhancements. In comparison, IAS 39 states that the fair value of a liability is affected by its credit risk (ie the credit risk related to the instrument, considering any related credit enhancements). Some respondents argued that a literal reading of this might result in a difference in the fair value of a liability under IFRSs and US GAAP. These respondents pointed to the following situation:

> An AA-rated entity acquires a BB-rated entity. The BB-rated entity had outstanding debt. The debt has no guarantees, collateral or other credit enhancing features.

20 Which credit rating should be reflected in the valuation of the liability? Some respondents indicated that IAS 39 might cause the AA-rated entity to value the debt reflecting the credit risk associated with the instrument (which is BB) because IAS 39 states that 'fair value reflects the credit quality of the instrument' (paragraph AG69). In contrast, some respondents stated that Statement 157 would cause the AA-rated entity to conclude that the debt should be valued reflecting its own credit standing, which is AA-rated immediately before the acquisition, but which might be somewhere between AA-rated and BB-rated after the acquisition *depending on the effect of the business combination on the acquirer*.[3] However, the staff thinks this is an area in which IFRSs and US GAAP have the same concept, but use different words. Clearly, the credit quality of an instrument depends on both the terms

[3] This is consistent with EITF Issue No. 98-1, 'Valuation of Debt Assumed in a Purchase Business Combination,' which explicitly addresses the above situation and states that the credit rating of the 'acquiring (combined) entity' should be considered.

of the instrument and the credit quality of the entity that issued it. In the absence of guarantees, collateral or other terms that affect the credit quality of the instrument, it is unlikely that under either IFRSs or US GAAP the credit rating of the instrument would be different from that of the combined (post-transaction) entity.

21 Some respondents observed that, with the exception of the requirement in IAS 39 to include the credit risk related to a financial liability in its fair value measurement, IFRSs do not include any guidance or explicit requirements to include non-performance risk in the fair value of a liability. These respondents stated that, in their view, differences in fair value of non-financial liabilities might develop as practice under Statement 157 emerges. The staff agrees with respondents that this is possible, but observes that participants used consistent methodologies and assumptions in valuing the non-financial liabilities in the case study. As such, the staff thinks the divergence in this area is unlikely to be significant.

SUMMARY

22 Based on the responses to the case study, discussions with participants in the working group and a comparison of the provisions of Statement 157 and fair value measurement guidance in IFRSs, the staff reasons that fair value measurements under IFRSs and US GAAP in a business combination will be consistent in most cases.

23 The staff thinks the possible differences discussed in this paper will not be present in most business combinations. Respondents stated that the assumptions, inputs, models and methods used in measuring the fair value of assets acquired and liabilities assumed in a business combination will generally be consistent under IFRSs and US GAAP. Furthermore, the staff believes that differences between IFRSs and US GAAP discussed in this paper are likely to be temporary given the commitments of the IASB and the FASB in the Memorandum of Understanding to issue converged fair value measurement guidance. Lastly, in the absence of clear guidance in IFRSs, the staff understands that practitioners often consider the provisions of other accounting frameworks or will rely on valuation best-practices. Because of

this, it is likely that preparers, auditors, and valuation and appraisal specialists will consider (though not necessarily adhere to) the provisions of Statement 157 in the absence of clear guidance or consistent practice under IFRSs.

STAFF RECOMMENDATIONS

24 The staff recommends that:

- a **the FASB decide that measurement attribute in a business combination is fair value, as defined in Statement 157**: Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- b **the IASB affirm that the measurement attribute in a business combination is fair value, as defined in IFRSs**: Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

25 The staff recommends that the GAAP differences identified by participants, as outlined in this paper, should be addressed as part of the IASB's Fair Value Measurements project. Otherwise, any guidance provided in the business combinations standard could be viewed by some as presupposing the outcome of the Fair Value Measurements project.

26 However, some of the matters discussed in this paper are not GAAP differences, but are situations in which the IASB and FASB have consistent concepts, but have used different words to articulate those concepts. The staff includes the following items in this category:

- a the requirement to reflect non-performance risk in the fair value of a liability under Statement 157 and the requirement to reflect the credit standing in the fair value of a liability under IAS 39; and
- b the concepts of market participants under Statement 157 and 'knowledgeable, willing parties in an arm's length transaction' in IFRSs (as described in IAS 40.42-44). In other words, both are market-based measures.

27 The staff recommends that the basis for conclusions of the revised IFRS 3 contain language that articulates the boards' view that IFRSs and US GAAP have the same concept for these matters, but use different words to communicate these concepts. *[Remainder of the paragraph omitted from observer note]*

QUESTIONS FOR THE BOARDS

28 Does the FASB agree that fair value, as defined in Statement 157, is the measurement attribute in a business combination?

29 Does the IASB affirm that fair value, as defined in IFRSs, is the measurement attribute in a business combination?

30 Do the IASB and FASB agree with the staff's proposed language for the basis for conclusions?

Business Combinations

Case Study:
Valuation of assets acquired and liabilities assumed in a business combination

Objective

1 The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) stated in the Business Combinations Exposure Draft that fair value was the appropriate measurement attribute for assets acquired and liabilities assumed in a business combination. During redeliberations, the Boards have discussed whether to retain the definition of fair value that is in the exposure draft or to use a different definition of fair value based on other projects that have developed since the exposure draft was issued.

2 In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. Statement 157 changes the definition of fair value under US GAAP. Statement 157 defines fair value as:

> the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

3 The IASB has an ongoing project on fair value measurements, but a final standard is not likely to be issued before the final business combinations standard becomes effective in January 2009. Therefore, the IASB has decided that it will use the existing definition of fair value in IFRS 3 *Business Combinations* in its final business combinations standard. IFRS 3 defines fair value as:

> the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

4 As a result, the measurement attribute 'fair value' might result in different values for assets and liabilities depending on whether the valuation is done in accordance with IFRSs or US GAAP. At their joint meeting in October 2006 the Boards discussed whether (and if so, when) the different definitions of fair value could lead to different measurements under US GAAP and IFRSs. The Boards therefore directed the staff to

prepare an analysis that will help them understand the consequences of retaining different definitions of fair value in a final business combinations standard.

5 To do this, we have developed a case study, which is presented in this paper and in the accompanying appendices. Feedback from the working group will be used to inform the Boards of the possible differences that might result in a business combination based on the different definitions of fair value under US GAAP (Statement 157) and IFRSs. This case study assumes that all assets and liabilities acquired are required to be recognised at fair value. *For US GAAP, fair value is determined in accordance with Statement 157, including its impact on FASB Statement No. 141,* Business Combinations*. For IFRS, fair value is determined using the existing definition and guidance in IFRSs. For the purposes of this case study, please disregard the guidance provided in paragraph B16 of IFRS 3.*

6 We will not attribute the views and conclusions to specific participants in the working group. Further, the views expressed by members of the working group are presumed to be their own and not the views of the entity they represent.

7 [Paragraph from observer note]

Scenario

8 On 1 January 2007 Company A, an international semiconductor manufacturing and distribution company, acquired all outstanding shares of Company B, a national semiconductor manufacturing and distribution company, for approximately CU1.1 billion in cash. As a result, Company A acquired all assets and assumed all liabilities of Company B.

9 The acquisition was the result of an active bidding process. Company A was one of many companies actively bidding for Company B. No companies bid for individual assets and liabilities and no companies bid for individual business units or operations. The details of the bids made by the other companies are not known to Company A.

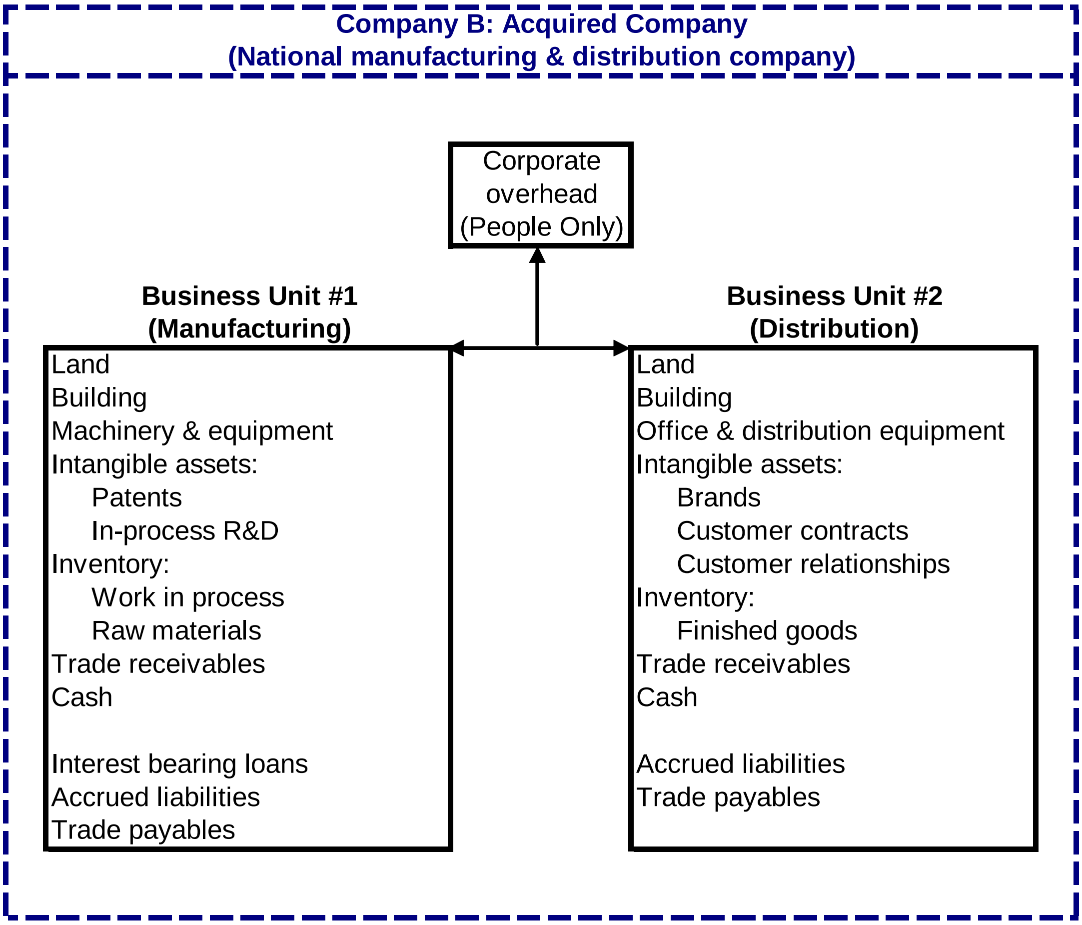
10 The composition of the bidders for Company B is as follows:

- two national competitors,

- four international competitors (of which Company A was one), and
- one private equity firm.

11 Company B is comprised of two business units: a manufacturing unit and a distribution unit. The manufacturing unit and the distribution unit are equivalent to cash generating units under IFRSs or reporting units under US GAAP. All sales to external parties are made by the distribution unit. Sales between the manufacturing unit and the distribution unit are at arm's length. Company B also has a small corporate overhead function comprised of the offices of the CEO and CFO. For simplicity, this case study assumes that the assets and liabilities at the corporate office are insignificant.

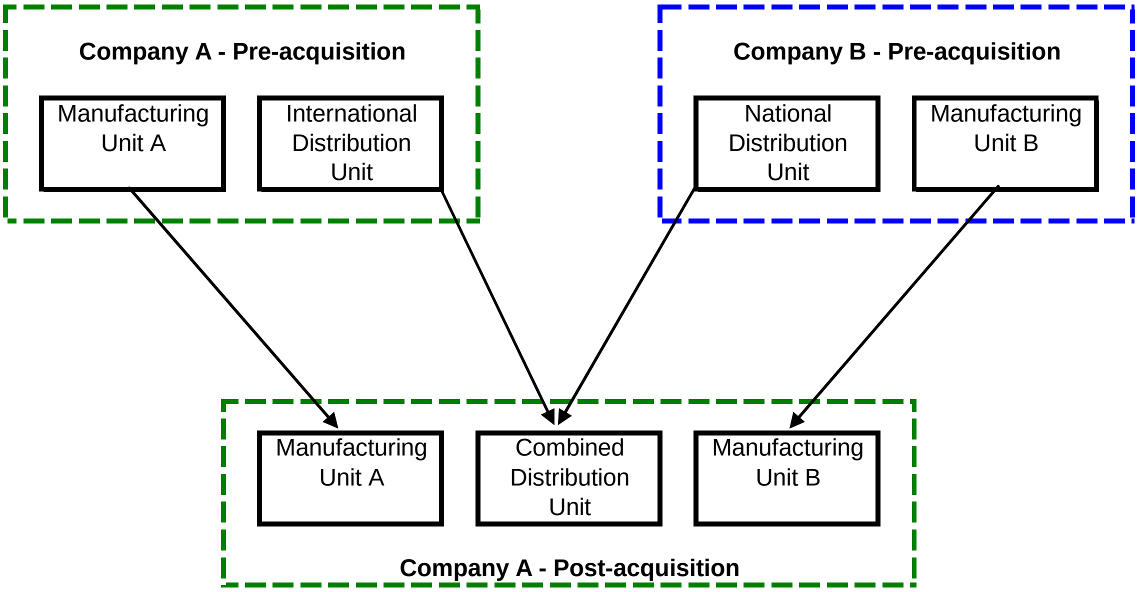
12 The following assets and liabilities of Company B have been identified:



13 Company A has a specialised manufacturing process that will allow it to realise synergies in addition to those that could be achieved by the market participants.

Management of Company A expect that these synergies will lead to a reduction of manufacturing costs in both Company A and Company B. In addition, Company A expects that, as a result of the acquisition, it will be able to reduce headcount by 10% in its existing distribution operations as well as 10% in Company B's distribution operations.

14 The following diagram illustrates how Company A plans to incorporate Company B's operations into its organisation:



Other information

15 The following additional information is provided as part of the case study:

a Appendix A includes general information about the assets acquired and liabilities assumed.

b Appendix B contains historical and projected financial information for Company B, prepared by Company B's management. The figures in Appendix B are for Company B on a standalone basis and have been taken from Company B's long-term business plan. *[Appendix B omitted from observer note]* c Appendix C contains a forecast of expected synergies. The forecast was prepared by Company A's management during the due diligence process. *[Appendix C omitted from observer note]*

d Appendix D contains information related to the various market participants. *[Appendix D omitted from observer note]*

16 This case study presumes that the assembled workforce is not considered a separable asset for financial reporting purposes. Additionally, for simplicity, this case study ignores deferred tax assets and deferred tax liabilities.

17 Company A determined the price paid for Company B based on a 4x revenue multiple, plus the present value of the expected headcount reductions in Company B, plus the present value of 50% of the expected entity-specific synergies (after tax). Company A believed that it needed to pay for at least some portion of its entity-specific synergies to be successful in the bidding process. The purchase price was calculated as follows (in CU thousands, except revenue multiple):

Revenue multiple	4.0
2007 revenue (rounded)	249,000
Enterprise value	996,000
Plus: cash and equivalents	52,000
Plus: synergies (rounded)	34,000
Purchase price (cash paid)	1,082,000

Consistent with the tentative decisions made by the IASB and the FASB to date, the purchase price of CU1.082 billion is presumed to be the fair value of Company B as a whole as of the acquisition date (1 January 2007).

18 Company B's manufacturing unit is the sole supplier to its distribution unit. The manufacturing unit does not sell to any third parties and the distribution unit does not have any third party suppliers. The manufacturing unit sells to the distribution unit on a fully-burdened 'cost plus' basis, with the mark-up currently at 50%, which is considered arm's length.

19 There are synergies between and within Company B's business units.

20 The identifiable intangible assets and goodwill on Company B's balance sheet relate to acquisitions previously completed by Company B. The identifiable intangible

assets acquired include trade names and trademarks, customer contracts and relationships, existing technology, and in-process research and development. No detailed information is available with regard to valuations of the individual assets (both tangible and intangible) acquired in previous acquisitions.

21 Company B's revenue in 2007 is expected to decline by nearly 10% from 2006 levels due to an overall slowdown in the market, which is expected to affect all of Company B's customers equally. Company B expects that this will have a short-term effect on 2007 and will have no effect on revenue growth in 2008 and beyond, but gross margins are likely to be affected in the future.

22 Company B saw a decrease in working capital in 2006. This was due to a reduction in prepaid expenses and an increase in accrued employment expenses and advertising costs. Company B's management does not believe this is a sustainable level and expects working capital levels to return to historical levels in 2007.

23 There are no active or inactive markets for the acquired intangible assets on a separate basis.

24 Company B's fiscal year end is 31 December.

25 All figures are in thousands of currency units (CU), unless otherwise noted.

Questions for the working group

26 When answering the following questions, please provide the basis for your conclusions and include relevant IFRS and US GAAP references as applicable.

Question 1: How would you proceed in valuing the assets acquired and liabilities assumed under US GAAP (Statement 157)?

- how would you consider the in-use versus in-exchange valuation premises for the assets acquired?
- how would you identify the principal (or most advantageous) market for the assets and liabilities?
- would market participants for individual assets and liabilities be different from the market participants that were bidding to acquire Company B? If so, how would you identify them?

Question 2: Unlike Statement 157, IFRSs do not include a discussion of the highest and best use of assets. Additionally, IFRSs do not contain guidance on identifying on which market a fair value measurement should be based. IFRSs also do not define fair value as either an entry price or an exit price.

- Would these factors possibly lead to a different valuation premise under IFRSs compared to US GAAP?
- Are there other matters, not mentioned above, that would affect the valuation premise? If so, how might this affect the valuation?

Question 3: What valuation techniques would you likely use in measuring the fair value of the assets acquired and liabilities assumed?

- Where would you obtain the inputs for the valuation techniques?
- Would you use the same techniques and inputs under both IFRSs and US GAAP? If not, how would they differ and why?

Question 4: How would the future tax deductibility of the depreciation or amortisation related to the assets acquired be incorporated into their fair values under US GAAP or IFRSs if:

- the amortisation of the asset is deductible to market participants but not to Company A?
- the amortisation of the asset is deductible to neither market participants nor Company A?
- Does it depend on whether the amortisation of the asset would be deductible in an asset acquisition (even if it cannot be deducted in a share acquisition) in the country in which the asset is located?

Question 5: In summary, how would the asset and liability valuations potentially differ under IFRS compared to US GAAP? How would, for example, differences in market participant assumptions, unit of valuation, treatment of synergies, and any other factors result in differences in the fair values of the assets and liabilities?

Form of response

[Paragraph 27 and 28 omitted from observer note]

Note: This case study assumes that all assets acquired and liabilities assumed will be recorded at fair value on Company A's group financial statements. The Boards have not yet reached a final decision as to whether this is appropriate in a business combination. As such, this is an assumption made only for purposes of this case study.

Assets and Liabilities	Manufacturing Unit	Distribution Unit
Patents	Company B has one patent related to its manufacturing technology and one patent related to an in-process R&D project. The patent related to the manufacturing technology is protective and does not generate revenue. The patent was obtained 10 years ago and expires in 15 years. The IPR&D project is expected to generate revenue once it is completed and launched. The patent was obtained 2 years ago, when development began, and expires in 23 years. The IPR&D project is referred to as Project 2 and is discussed in more detail below. Both patents are usable worldwide, although Company B only uses them in the country in which it is located. The patents are not renewable.	n/a
IPR&D	There are two R&D projects at the time of the acquisition date. Both projects meet the definition of an IPR&D project under both US GAAP and IFRSs. ▪ The first project (Project 1) is a machine monitor that manages the computing power of a machine to increase efficiency in an environment in which users increasingly rely on computing power for everyday tasks. Development on this project began 2 years ago and is expected to be completed in 2009. ▪ The second project (Project 2) is based on human activity recognition, which automatically infers a wide range of human activities and provides proactive assistance, if needed, to complete an activity. This will	n/a

Assets and Liabilities	Manufacturing Unit	Distribution Unit
	allow manufacturing companies to employ fewer machine operators. Market research shows market acceptance is likely to be positive. This project will be used internally and will be sold as a separate product. Development on this project began 3 years ago and is expected to be completed in 2010. Company A intends to complete the development of Project 2 (in fact, this project is one of the main reasons that Company A acquired Company B) and abandon Project 1 because it would conflict with a product already in Company A's portfolio.	
Brands, trademarks and trade names	n/a	Company B has three product brands and one company trade mark that are clearly marked on all products. Products are sold to businesses, which then incorporate them into their products. Company A intends to continue the use of the Company B trade mark on all products, except it will be modified to indicate that it is a division of Company A.
Customer contracts and relationships	n/a	Company B has ten customers (mainly original equipment manufacturers) that make up 80% of its sales. There are twenty customers in total. Customers are contracted for two year terms with automatic renewals. The top ten customers have, to date, always renewed their contracts and have been doing business with Company B for an average of 10 years. On average, Company B loses 1.5 customers per year. Company A has two of Company B's top 10 customers (Customer 5 and Customer 8). One customer, Customer 2, has an exclusive contract with Company B and is prohibited from buying competing products from another distributor. Of the total marketing and advertising expenditures of Company B, 30% relate to the maintenance of current customers and the remainder is spent on acquiring new

Assets and Liabilities	Manufacturing Unit	Distribution Unit
		customers.
Land	The land is shared with the distribution unit. Of the 5 hectares owned, the manufacturing unit uses 60%. It has no distinguishing characteristics. The current market price for similar land in the area is CU100 per square metre. The highest and best use of the land is related to the activities for which it is currently being used.	The land is shared with the manufacturing unit. The distribution unit uses 40% of the 5 hectares owned by Company B. It has no distinguishing characteristics. The current market price for similar land in the area is CU100 per square metre. The highest and best use of the land is related to the activities for which it is currently being used.
Building	The manufacturing building is owned by Company B and has a net usable area of 3,500 square metres. It was built for purpose but could be used by other, similar entities with minimal alterations. The highest and best use of the building is related to the activities for which it is currently being used. The facility was constructed 10 years ago and there have been no major additions or renovations since construction. The facility is in good condition.	The building is owned by Company B and is a general purpose office building and warehouse with a net usable area of 1,500 square metres. The facility was constructed 10 years ago. There have been no major additions or renovations and the facility is in good condition. Because of the high rate of development in the area, the highest and best use of the building is different from that for which it is currently being used. An alternative use would be as a sporting goods store (for the office building) and a practice centre (for the warehouse).
Machinery & equipment	The machinery and equipment is customised for Company B’s specific needs and could only be used to manufacture Company B’s patented product. All equipment was purchased new and is in good condition. Company A intends to dispose of a portion of the equipment because it overlaps with the equipment currently owned by Company A. The carrying value of the equipment to be disposed of is CU5 million. Other market participants would not sell this equipment. Company A has negotiated a selling price of CU7 million with an independent third party. Aside from the equipment that will be sold, no equipment is expected to be retired or removed.	n/a
Office & distribution equipment	n/a	The office and distribution equipment is general purpose. All equipment was purchased new and is in good condition.

Assets and Liabilities	Manufacturing Unit	Distribution Unit
		None of the equipment is expected to be retired or removed.
Finished goods inventory	n/a	The finished goods inventories are purchased from the manufacturing unit at arm's length prices. There are no third party suppliers. The finished inventory is labelled and shipped from the distribution unit facility. There are no obsolete or slow-moving inventory components.
Work in process inventory	The WIP is 40% complete on average.	n/a
Raw materials inventory	Raw materials consist of the basic materials the company needs to manufacture its end products.	n/a
Cash	All cash is used in the operations of the business. A portion of the cash (CU10 million) is used as collateral for the debt. The collateral will be required post-acquisition by Company A, but would not be required by a company with a credit standing of AA or higher.	All cash is used in the operations of the business. There are no restrictions on the use of the cash.
Trade receivables, trade payables, other current assets and other current liabilities	▪ Trade receivables relate to the sale of inventory to the distribution unit. ▪ Trade payables relate to the day-to-day operations of the business. ▪ Other current assets include pre-paid expenses. ▪ Other current liabilities include accrued employment expenses and taxes.	▪ Trade receivables relate to the sale of inventory to external customers. ▪ Trade payables relate to the day-to-day operations of the business, including purchases from the manufacturing unit. ▪ Other current assets include pre-paid expenses. ▪ Other current liabilities include accrued employment expenses, advertising costs and taxes.
Debt	The debt has a par value of CU17 million with a credit rating of BB and the interest rate is fixed at 7.5%. It matures in 10 years. The coupon payments are paid annually at the end of each calendar year.	n/a
Contingent liability	As of the acquisition date Company B has one potential contingent liability related to an employment tax assessment. The employment tax authority in the jurisdiction in which Company B is located has audited Company B's statements for the past two years and has	n/a

Assets and Liabilities	Manufacturing Unit	Distribution Unit
	made an assessment of additional employment taxes owed. Company B believes it has in fact underpaid the employment taxes, but does not agree with the amount of the assessment and has appealed it. If the employment authority prevails, Company B’s employment taxes due for the two years could increase by, at most, CU12 million but at least CU5 million (both figures include penalties and interest levied by the employment tax authority). Company B is uncertain as to the likelihood of it needing to pay as much as CU12 million, but estimates it to be 40%. Payment would be made within 2 years.	