PURCHASED GOODWILL IN INTERNATIONAL ACQUISITIONS. MICROSOFT-NOKIA CASE

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Abstract: *Purchased Goodwill appears when a company acquires another company. It can be defined as an intangible asset that arises as a result of the acquisition of one company by another for a premium value. International accounting bodies such as the IASC or the FASB require acquiring firms to record goodwill as an asset when they purchase a target firm and pay more than the fair market value of the identifiable net assets of that firm. As a consequence of these regulations, the goodwill appears in accounts of a company only when it acquires certain intangible assets that are not identifiable. Because the purchased goodwill arises in business combinations this concept is detailed in the standards on business combinations (FAS 141 and IFRS 3) rather than those on intangible assets and goodwill (FAS 142 and IAS 38). In this paper I present the modality in which is perceived currently the purchased goodwill and its components. In the present it is considered that the purchased goodwill is the result of an evaluation made by the bidding company over the target company and appreciating the contribution of it to the achievement of the strategic objectives of the purchaser. Goodwill is perceived as the sum of the present values of the additional cash-flows that can be generated at the level of acquiring company as result of acquisition. The sources of these future additional cash-flows are considered, in the present, unidentifiable intangible assets of the target company and the estimated synergies between entities that will combine. In the final part of my working paper I have analysed the level and the components of the goodwill that was paid in the Microsoft-Nokia transaction. As is reflected in the Microsoft Annual Report 2015 (Note 9 Business Combination), "the goodwill had a proportion of 37% in the value of total acquired assets and, was primarily attributed to the increased synergies that were expected to be achieved from the integration of NDS ". In this paper I present the results of my analysis related by the types of synergies that was estimated to be obtained as result of this transaction.*

Keywords: *goodwill, company, purchase, price, assets, intangible*

JEL classification: G32

1. The accounting rules with respect to the businesses combinations.

Purchased Goodwill appears when a company acquires another company. It can be defined as an intangible asset that arises as a result of the acquisition of one company by another for a premium value.

In 2001 in USA were issued the SFAS 141 “Business Combinations” and of SFAS 142 “Goodwill and Other Intangible Assets”. In Europe in 2004 were introduced the IFRS 3 “Business Combinations*”* in conjunction with IAS 38 “Intangible Assets“.

The US Financial Accounting Standards Board (FASB) and International Financial Reporting Standards (IFRS) require, for all acquisitions, the application of Purchase Price Allocation procedure (PPA). This is the process of allocating the cost of an acquired entity to its tangible assets, intangible assets, and assumed liabilities (including contingent liabilities), based on their respective fair values. After an acquisition whereby the acquiring company obtains control of the target, the acquirer has to disclose a PPA in its annual report. Consistent with the asset deal notion, all assets and liabilities have to be valued at their fair value from the acquisition moment.

According to FAS No. 141, the cost of the acquired company must, for accounting purposes, be divided, at the acquisition date**,** among the acquired assets and liabilities of the target company using the following principles:

„All identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to the fair values at the date of acquisition; the excess cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill”.

According to SFAS 141 and IFRS 3 the acquiring company must reflects in its consolidated financial statements the all intangible assets of the target company regardless of the fact that they are identifiable or unidentifiable.

According to these accounting standards *the identifiability criterion* distinguishes goodwill from identifiable intangible assets of the company. An intangible asset is identifiable if it meets either *the contractual-legal criterion (*assets arise from contracts or other legal rights*) or the separabiity criterion (*assets are able to be divided by the acquired company), Intangible assets that do not meet these recognition criteria must be recorded as goodwill.

Under the acquisition method, the acquiring company must recognize separately in its balance sheet all identifiable intangible assets of the target company, including those that has not been recognized previously by the acquire. In such category of intangible assets that were absent from the balance-sheet of the purchased company are comprised internally generated intangible assets of this.

The intangible assets that must be recorded separately in a purchase price allocation procedure have been divided into five categories:

-marketing-related assets (trademarks, trade names, internet domain names, noncompetition agreements, etc.);

-customer-related assets (customer lists, customer contracts, customer relationships, etc.);

-contract-based assets (licensing agreements, advertising contracts, construction contracts, employments contracts, etc.);

- technology-based assets (patented technology, computer software, databases, unpatented technology, etc.);

- artistic-related assets (plays, operas, ballets, books, musical work, etc.).

2. The Definition and Components of Purchased Goodwill

International accounting bodies such as the IASC or the FASB require acquiring firms to record goodwill as an asset when they purchase a target firm and pay more than the fair market value of the identifiable net assets of that firm. As a consequence of these regulations, the goodwill appears in accounts of a company only when it acquires certain intangible assets that are not identifiable.

Because the purchased goodwill arises in business combinations this concept is detailed in the standards on business combinations (FAS 141 and IFRS 3) rather than those on intangible assets and goodwill (FAS 142 and IAS 38).

Goodwill is defined especially in terms of its calculation method.

The purchased goodwill can be approached from two points of view:

-quantitative point of view;

-qualitative point of view;

From a *quantitative point of view* (named also as Top-Down Approach), goodwill is viewed as the part of the purchase value that is not possible to allocate to the purchased identifiable assets. According to SFAS No. 141 purchased goodwill is "the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed." The glossary of the IFRS 3 "Business Combinations" defines goodwill as "any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction".

From a *qualitative point of view* (named also as Bottom-Up Approach), goodwill is viewed in terms of its components. Purchased goodwill represents the value of all unidentifiable intangible assets that are obtained as result of the acquisition of another company. It is viewed as a price premium that is paid for the acquisition of valuable unidentifiable intangible assets of the target company that can contribute to generating of additional economic benefits.

According to IASB 2008 goodwill can be specified as ``an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized``

FAS 141 highlights that „intangible assets that are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole are classified as *goodwill*".

In the present it is considered that the purchased goodwill is the result of an evaluation made by the bidding company over the target company and appreciating the contribution of it to the achievement of the strategic objectives of the purchaser. Goodwill is perceived as the sum of the present values of the additional cash-flows that can be generated at the level of acquiring company as result of acquisition.

The sources of these future additional cash-flows are considered in the present: unidentifiable intangible assets of the target company and the estimated synergies between entities that will combine.

SFAS No.141 and IFRS 3 highlight that the purchased goodwill comprises a number of components as:

1) the fair value of the going concern element of the target company (going-concern goodwill);

2) the fair value of the expected synergies expected from combining of the two business; (synergy goodwill);

3) payments resulting from overvaluation or undervaluation of the assets and liabilities of the target company;

4) purchase premiums paid (or discounts obtained) as result of negotiation process of transaction.

According to these standards first two components are considered „true goodwill" or "core goodwill". From an economic point of view goodwill includes those assets that do not satisfy the condition to be identifiable and, the expected synergies reflected in the price that a company agree to pay for other company. The additional payments generated by overvaluation of the target company and transaction negotiation process form the "residual goodwill".

Going-concern goodwill

Johnson and Petrone (1998) define going-concern goodwill as: "the ability of a stand-alone business to earn a higher rate of return on an organized collection of net assets than would be expected if those assets had to be acquired separately".

The sources of going-concern goodwill of the target company can be grouped into two categories:

-synergies between identifiable assets of it;

-other unidentifiable intangible assets that cannot be separately recognized in the financial situations of the company;

In the category of *unidentified intangibles* that a company cannot account for in its financial statement but that are responsible for driving a superior earning power are included: assembled workforce, customer base, customer service capability, market position, outstanding credit ratings, favourable government regulations, etc (IFRS 3).

Synergy goodwill

Johnson and Petrone (1998) highlighted that an important component of the goodwill is the fair value generated by the combining the businesses and net assets of the two companies. This is *the combination goodwill* and reflects the value that arises from expected synergies between the acquirer and the target firm.

Henning et al. (2000) had defined synergy goodwill as the synergistic value created by the acquisition,

The combination of two companies can generate an increasing of revenues and/or a decreasing of costs at the level of the combined entity. These may be the result of management improvement, economies of scale, cross-selling opportunities, the improvement in production techniques and marketing methods, integration of resources, and more efficient uses of resources.

The synergies are unique to each combination and different combinations would produce different synergies and, hence, different values. Synergies must be allocated to goodwill because these are generally not identifiable.

3. Purchased Goodwill in the case of Microsoft-Nokia Transaction

On 25 April, 2014, Microsoft acquired the Nokia's Devices and Services business for a total purchase price of $9.442 billion, including cash acquired of $1.5 billion.

By acquiring Nokia's Devices & Services segment, the major goal for Microsoft was „to accelerate the growth of shares and profits in mobile devices through faster innovation, increased synergies, and unified branding and marketing"(Microsoft Annual Report, 2015).

As is reflected in Microsoft Annual Report 2015, the major classes of assets and liabilities to which was allocated the purchase price were as follows:

Assets and Liabilities	**Amounts** (in millions $)	As a % of Total Assets Acquired
Cash acquired	1,506	10%
Accounts receivable	754	5%
Inventories	544	4%
Other current assets	936	6%
Current Assets	3,740	25%
Property and equipment	981	7%
Fixed Assets	981	7%
Intangible assets	4,509	30%
Goodwill	5,456	37%
Other	221	1%
Total Assets	14,907	100%
Current liabilities	4,575	
Long-term liabilities	890	
Total Liabilities	5,465	
Total purchase price	9,442	

Source: Microsoft Annual Report 2015, Note 9 Business Combination

As result of this transaction Microsoft has obtained a significant quantity of goodwill and identifiable intangible assets. The proportion of these in the total value of acquired assets was the 67%.

As is reflected in the Microsoft Annual Report (2015) "the goodwill was primarily attributed to increased synergies that were expected to be achieved from the integration of NDS ".

It was estimated that the acquisition of Nokia's Devices and Services business by the Microsoft will bring valuable synergies

At the point of acquiring Nokia phone business by Microsoft, Nokia was a downstream customer to Microsoft, while Microsoft was an upstream supplier to Nokia (Toriola, S. J., 2015). It was considered that vertical integration will help

Microsoft reduce costs and increase profits and combined company will become more cost-efficient and profitable.

It was estimated that Nokia acquisition brings some key capabilities to Microsoft that will allow the reducing the costs and increasing the growth. As result of acquisition, Microsoft will gain access to assets like Nokia's manufacturing facilities, patents, engineering talent, supply and distribution network, etc.

In a letter addressed to Microsoft staff referring to Nokia acquisition, Steve Ballmer the Microsoft chief mentioned (Sept.3, 2013):

"Microsoft acquired Nokia's smart phone and mobile phone businesses, its design team, most of its manufacturing and assembly facilities and operations, and sales and marketing support The acquisition also brings key capabilities around supply chain, distribution, operational processes and systems and skill in managing hardware margins to Microsoft. The unified company will benefit from speedier execution and best-in-class business operations [..] In addition to their innovation and strength in phones at all price points, Nokia brings proven capability and talent in critical areas such as hardware design and engineering, supply chain and manufacturing management, and hardware sales, marketing and distribution.[...] This is a smart acquisition for Microsoft, and a good deal for both companies. We are receiving incredible talent, technology and IP"

Two types of operating synergies:

The estimated operating synergies were divided in two types:

-*revenue synergies*

-and *cost synergies.*

Cost Synergies

The costs are considered the most reliable source of synergy in the case of combination of two companies (Hillario L. F., 2011). It was estimated that the consolidation process between Microsoft and Nokia will lead to considerable savings in the operating expenses.

In a document published by Microsoft entitled Microsoft`s Strategic Rationale for deal (sept.3, 2013), the company said that the transaction could create annual cost synergies of $600 million within 18 months after its close.

These reductions in operating expanses will be especially the result of unified branding and marketing, of restructuring program planned to be implemented after acquisition.

It were estimated the reductions in wage expenses as result of job cuts in manufacturing, engineering, marketing and other areas where appears overlap with the Microsoft business. Also, were estimated the reductions in other types of operating expenses (design, manufacturing, sales, marketing, supply) as result of restructuring of manufacturing facilities and consolidation of the marketing, sales, and supply chains.

Revenue synergies

Revenue synergies can be achieved through a combination of different functional strengths. It was considered that as result of Nokia`s acquisition by Microsoft will be created new business opportunities. It was estimated that by combining their different strengths, Microsoft's software development and marketing campaign with Nokia's product line, hardware manufacturing expertise and distribution network, the combined entity may achieve new markets and higher growth in existing ones.

Stephen Elop, former Nokia CEO that was named, after the acquisition, the executive vice president of the Devices Group at Microsoft, said within the Microsoft Nokia Transaction Conference Call (sept.3, 2013): "Building on our successful partnership, we can now bring together the best of Microsoft's software engineering with the best of Nokia's product engineering, award-winning design, and global sales, marketing and manufacturing."

Steve Ballmer, Microsoft executive chief, highlighted within the same press conference that:

"It's a bold step into the future — a win-win for employees, shareholders and consumers of both companies. Bringing these great teams together will accelerate Microsoft's share and profits in phones, and strengthen the overall opportunities for both Microsoft and our partners across our entire family of devices and services."

It was considered that, as result of acquisition, Microsoft can focuses on integrating of its Windows Phone OS and the other platforms into mobile devices and expands its mobile market share.

By acquiring Nokia's Devices & Services segment Microsoft aimed to gain a stronger position in the hardware devices segment. It was estimated that "the acquisition of the Nokia Devices and Services business will enable Microsoft to accelerate its share of smartphones and feature phones in developed and emerging markets, and increase its role as a devices and services company"(Microsoft News Canter, April 25, 2014). Microsoft believed that it must have a mobile handset device business if it wants to compete with Google and Apple.

By acquiring Nokia's Devices & Services segment, an important goal for Microsoft was to gain access to the hardware platform for its mobile phone software. The Microsoft hoped that this acquisition could accelerate development on its windows phone platform.

According to Toriola, S. J. (2015) "the strategic intent of the Microsoft at the point of acquiring Nokia phone business was to push for the usage of its signature Windows operating system in mobile phone industry Nokia".

At a press conference in Espoo, Finland, on sept.3, 2013, Ballmer highlighted the importance of the deal for Microsoft. CEO Microsoft mentioned that Windows Phone will improve the health of the entire Windows ecosystem. The Microsoft hoped that a high market share in handheld devices will affect its market share in the PC industry. The increased smartphone sales will lead to increased tablet sales, and increased tablet sales will lead to increased PC sales.

The aim of Microsoft was to accelerate the growth of its share and profit in mobile devices through faster innovation. The hopes was that the two companies will combine assets and know-how to jointly develop new smartphone technology.

As Stephen D. Simpson (2011) highlighted, „the two companies hope that Nokia's distribution network and hardware capabilities can mesh with Microsoft's software development and create a platform that can challenge Apple, Google and the other smartphone leaders [...] Microsoft had big hopes for dominating the mobile market like it had dominated the desktop market”.

Conclusions:

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The estimated operating synergies were divided in two types: *revenue synergies* and *cost synergies.*

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