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Purchased goodwill and types of synergies in businesses combinations. Microsoft-LinkedIn transaction

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Abstract

According to International and national accounting bodies such as the IASC or the FASB, purchased goodwill is considered, in the present, an intangible asset that appears as a result of the acquisition of one company by another, for a price premium. It is the amount that makes the balance between the purchase price of the target company and the value of all identifiable acquired assets (tangible and intangible) and liabilities.

From an economic point of view, this price premium that is paid in businesses combinations must be justified by the estimated future additional net profits and free cash-flows that can be obtained by the acquiring company as result of investing in the target company.

One of the most important sources of these additional earnings are the estimated synergies between the companies implied in combination. These can explain the significant price premiums paid in most acquisitions made by strategic investors. This paper focuses on the Microsoft-LinkedIn transaction, trying to identify the price paid in this acquisition, the size of the purchased goodwill and, the value and types of synergies that have been estimated for this combination of companies.

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1. Purchased goodwill and types of synergies in businesses combinations

1.1 *The purchased goodwill: concept and components*

The introduction of the new accounting standards for business combination in USA (SFAS 141 in 2001) and Europe (IFRS 3 in conjunction with IAS 38 in 2004) has change fundamentally the accounting for business combinations, making them largely comparable between the European Economic Area and the United States.

In the United States, the process of accounting in the case of business combinations is conducted in accordance with the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards No. 141 (revised 2007) "Business Combinations" ("SFAS 141r") and SFAS 142 "Goodwill and Other Intangible Assets" ("SFAS 142").

In Europe the two standards mainly regulating this process are IFRS 3 Business Combinations and IAS 38 Intangible Assets.

According to SFAS 141 a business combination occurs when an enterprise acquires the net assets that constitute a business or equity interest of one or more enterprises and obtains control over that enterprise or enterprises.

One of the main features of IFRS 3 and SFAS 141 is that these require using the acquisition method as tool for accounting the business combinations. Under this method, the acquiring company must recognize, in its consolidated financial statements, the individual assets and liabilities (including contingent liabilities) of the acquired company. This recognizing is the result of conducting of a purchase price allocation process (PPA).

This process (PPA) is the accounting practice that implies allocation of the acquired company's cost to the Fair Value of acquired assets and liabilities (including contingent liabilities). The procedure includes also the establishing the useful lives of acquired identified assets.

As result of implementing the acquisition method, the target company is reflected in consolidated financial statements of the acquiring company, as if, the acquirer would purchase the individual assets and liabilities of the acquired company, instead of shares.

An important step in accounting for business combination, under the acquisition method, is the identification and valuation (determining the fair values) of all assets and liabilities of the acquired company.

In a subsequent step, the cost of acquisition will be allocated to all these identified and valued assets (tangible and intangible) and liabilities. For making this allocation, intangible assets of the target company are divided in two categories: identifiable and, unidentifiable intangible assets.

According to FAS 141 and IFRS 3 an intangible asset is considered identifiable if is satisfied one of the following two conditions:

- the asset is separable;
- or, the asset arises from a contractual or other legal right.

The identifiable intangible assets of the target company must be the subject (together with tangible assets) of separate valuation and recording in financial statements of the acquiring company. These 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, employment contracts, etc.);
- technology-based assets (patented technology, computer software, databases, unpatented technology, etc.);
- artistic-related assets (plays, operas, ballets, books, musical work, etc.).

Intangible assets that are not meeting the identification criteria are incorporated in goodwill (named purchased goodwill). In this category are comprised important resources of an entity such as: the quality of its employees; managerial talent; the quality of relationships with suppliers, banks, government, business partners; organization structure, company's culture, etc.

According to International and national accounting bodies such as the IASC or the FASB, purchased goodwill is considered, in the present, an intangible asset that appears as a result of the acquisition of one company

by another, for a price premium. It is the amount that makes the balance between the purchase price of the target company and the value of all identifiable acquired assets (tangible and intangible) and liabilities.

According to SFAS No.141, purchased goodwill is defined as „the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed”.

In the glossary of the IFRS 3 “Business Combinations”, goodwill is defined 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 an economic point of view, this price premium that is paid in businesses combinations must be justified by the estimated future additional net profits and free cash-flows that can be obtained by the acquiring company as result of investing in the target company. The sources of these additional results, for which a company may agree to pay a premium, can be divided in two categories, namely:

- the unidentifiable intangible assets that can be associated to the acquired company;
- the estimated synergies between the companies implied in combination

1.2 *The types of synergies*

One of the most important reasons that can explain the significant premiums paid in most acquisitions is synergy. The strategic buyers are concerned with identifying and valuing the synergies that can be obtained by acquisitions of other companies. These, are incorporated in prices that they agree to pay in the acquisition process. As is reflected by Damodaran (2005) ”synergy is the magic ingredient that allows acquirers to pay billions of dollars in premiums in acquisitions”.

Synergy was defined by Sirower (1997) as ”the increase in performance of the combined firm over what the two firms are already expected or required to accomplish as independent firms”. This surplus of performance determined by combination generates a surplus of value at the level of the combined company.

Synergy can be accordingly defined as the additional value that is generated by combining two companies. It appears when the value of the whole is greater than the sum of its parts. In the case in which the synergy is perceived to exist, the value of combined company (investment value) is higher than the sum of the market values of bidding and target companies (the values of these companies as standalone entities).

The synergies are divided by Damodaran (2005) in two important categories: operating and, financial synergies.

The additional benefits and value that is created at the level of combined company can be the result of cost savings and/or creating the incremental revenue opportunities. Accordingly, the operating synergies can be divided in *costs synergies* and *revenues synergies*.

As is defined by Investopedia, „cost synergy, in the context of mergers, is the savings in operating costs expected after two companies that compliment each other's strengths join”. The traditional sources of cost synergies are economies of scale and scope that can be generated at the level of different departments and activities of the new formed company.

Revenue Synergies represent the increase in operating revenues that can be obtained as result of integrating the assets and activities of bidder and target companies. Among the most important sources of revenue synergies can be mentioned: cross-selling and up-selling opportunities: extension on a new product or, service market: extension on new geographical markets: increases the selling prices as result of enhanced market power, etc.

Financial synergies are reflected in increasing debt capacity, tax benefits and, available cash for investments, at the level of the company that is formed as result of business combination.

2. Purchased Goodwill and the types of synergies in Microsoft-LinkedIn transaction

On June 13, 2016, Microsoft announced that plans to acquire LinkedIn, the world’s largest professional network on the Internet, for a price of \$26.2 billion. Microsoft was willing to pay a price of \$196-per-share which represented a 50 percent premium over LinkedIn’s closing price on June 10, 2016 (Microsoft Announce, June 13, 2016). On December 8, 2016, the transaction was completed for a preliminary total purchase price of \$27.0 billion (Microsoft Annual Report, 2016).

This acquisition was the largest in the history of Microsoft and combined two companies in two different industries: one in software industry with one in social network industry.

From the moment of spreading the news about this acquisition, the financial analysts have tried to respond to the following questions:

- why a billion dollars company like Microsoft wanted to by another billion dollars company like LinkedIn?
- why Microsoft has paid such a huge amount of money for a company which has reported an annual loss of 8 million dollars?
- the price paid for LinkedIn reflects the value of this company for Microsoft?

It is considered that the acquisition of LinkedIn is the result of Microsoft's current management efforts to reinvent and transform this company from the leading PC software maker to an entity that sells business technology services. The Microsoft is shifting to cloud computing, a model in which customers rent software and other services delivered over the internet. The publicly-known purpose of Microsoft presently is to sell online services to business customers. I consider that the acquisition of LinkedIn allows Microsoft to expand its dominance in the enterprise market which is considered the real source of earnings for it. Microsoft had announced that after the complete acquisition, LinkedIn would function completely as an independent platform headed by Jeff Weiner – CEO of LinkedIn.

2.1 Purchase Price Allocation and value of the goodwill

As is reflected in Microsoft Report for the quarter ended march 31, 2017 the cost of acquisition was allocated to different types of identified assets and liabilities "based on a preliminary valuation and, is subject to revision, as more detailed analyses are completed and additional information about the fair value of assets acquired and liabilities assumed becomes available". In table number 1 are reflected the modality in which have been made this allocation.

Table 1 Purchase Price Allocation. Microsoft- LinkedIn Transaction

Assets and Liabilities	Value in millions \$
Cash and cash equivalents	1,328
Short-term investments	2,110
Other current assets	697
Property and equipment	1,529
Intangible assets	7,887
Goodwill (a)	16,687
Short-term debt (b)	(1,323)
Other current liabilities	(1,117)
Deferred income taxes	(657)
Other	(132)
Total Purchase Price	27,009

Source: Microsoft Corp - Form 10-Q - April 27, 2017

As is reflected in Microsoft quarterly report (April 27, 2017) the value of the purchased goodwill is \$16.687 billion and this was assign to Productivity and Business Processes segment.

2.2 The value and types of synergies

The final price of \$27.009 billion dollars paid for LinkedIn highlights that the Microsoft attached to this company a much higher value than the amount that was put by the market. The Market Capitalization of LinkedIn at the acquisition moment (June 10, 2016) was of \$17.48 billion. Result that Microsoft paid, finally, a premium of \$9,529 billion above market value of LinkedIn.

There are two important reasons that can explain this high difference between the price paid by Microsoft and the market value of LinkedIn, namely:

- the capacity to control the company (control premium);
- the capacity to obtain synergies as result of acquisition and exploiting the company (synergy value).

An important reason that can explain the premium paid over the market value of the acquired company is the fact that the acquiring firm estimates that can obtain important synergies as result of the acquisition.

Important questions that have concerned the financial analysts were the following:

-what kind of synergies has been estimated by the management of the Microsoft?

-will the standalone value of LinkedIn plus the value of all synergies equal or exceed the purchase price of \$27.009 billion?

In this paper I have tried to respond, only, to the first question.

The management of Microsoft has anticipated that exist a lot of synergies between Microsoft and LinkedIn. As is reflected in Microsoft quarterly report (April 27, 2017) the value of the purchased goodwill is \$16.687 billion and “was primarily attributed to increased synergies that are expected to be achieved from the integration of LinkedIn”.

The announcement made by management of Microsoft with occasion of Microsoft-LinkedIn transaction (Microsoft Announce, June 13, 2016) highlights that, as result of companies ‘combination, will be generated two types of operating synergies: revenue and cost synergies. It is estimated that the value of potential revenue synergies is much higher than the value of cost synergies.

a) Revenue Synergies

It is considered that the acquisition of the LinkedIn by Microsoft could generate long-term revenue synergies because will be created new growth opportunities for both companies. As Satya Nadella, CEO of Microsoft, highlighted on June 13, 2016, in the press conference with the occasion of this combination:

"The LinkedIn team has grown a fantastic business centered on connecting the world's professionals. Together we can accelerate the growth of LinkedIn, as well as Microsoft Office 365 and Dynamics, as we seek to empower every person and organization on the planet."

The managers of the two companies were considered that the acquisition has a certain strategic sense because of the complementarities of the two companies ‘data assets: the professional graph and the professional cloud. It has been considered that the LinkedIn owns the best professional social database and Microsoft runs some of the most widely used office software.

As Tom Warren (June 13, 2016) highlighted:

"LinkedIn provides Microsoft with immediate access to more than 433 million members and a solid social graph that, thanks to its professional nature, is matched closely with the software and services Microsoft provides”.

Microsoft CEO Satya Nadella stated (June 14, 2016):”work today is split between *tools* to get jobs done (Microsoft Office) and professional *networks* (LinkedIn). The transaction will unify these two elements or, will bring together “the professional cloud and the professional network”

The transaction is considered a win-win movement for both companies

An important reason of LinkedIn’ acquisition was the access to the large base of LinkedIn’s users (433 million members) and LinkedIn’s data (Microsoft Announce, June 13, 2016). These can be used to generate synergies with the products and services provided by Microsoft including cloud services, Customer Relationships Management (CRM) and, its Office products.

The types of revenue synergies identified in Microsoft-LinkedIn transaction are the following:

- Cross-selling synergies;
- Up-selling Synergies;
- Synergies generated by extension on new service market.

- Cross-Selling Synergies

It is considered that the transaction could provide potential cross-selling opportunities. The transaction will determine the increase of Microsoft's sales of advertising, software and, business services, to LinkedIn's more than 400 million users. Also, the combination of companies can determine the attraction on LinkedIn, the employees of Microsoft 'enterprise customers who are not members of this social network.

- Up-selling synergies

Acquisition of LinkedIn corresponds to Microsoft's management concerns to expand and modernize the company's business products. It is estimated the Microsoft- LinkedIn combination will drive up-selling synergies as result of additional sales of Microsoft different products realized in conditions in which these will integrate LinkedIn. Has been identified opportunities for the two companies' products and services to work together. According to Nadella the company wants to create synergy between LinkedIn, on one part, and Microsoft Office 365 and Microsoft Dynamics, on the other part. Microsoft plans to integrate LinkedIn Newsfeed into their products like Outlook, Skype, or Office applications like Word, Excel and PowerPoint. Also, access to LinkedIn's data will be especially useful for Dynamics, Microsoft's customer relationship management software.

- Extension on a new service market

The acquisition of LinkedIn fits with current concerns of the Microsoft 'management to enter into new products and services markets in order to achieve the estimated growth. The transaction allows the opening of a large market to it in the form of human resources services.

b) Cost synergies

As management of Microsoft has been announced (Microsoft Announce, June 13, 2016) as result of Microsoft-LinkedIn combination, are estimated annual cost synergies in value of \$150 million by 2018. These will be the result of economies of scale generated across many types of activities: sales and marketing, research & development, IT, administrative etc.

3. Conclusions

One of the main features of accounting standards for businesses combinations (SFAS 141 in USA and IFRS 3 in Europe) is the requirement of recognizing, by the acquiring company, in its financial statements, of the individual assets and liabilities (including contingent liabilities) of the acquired company.

This recognizing is the result of conducting of a purchase price allocation process (PPA) that implies allocation of the acquired company's cost to the Fair Value of acquired assets and liabilities (including contingent liabilities). An important step in this process is the identification and valuation of all assets and liabilities of the acquired company.

The acquiring company must recognize separately in its balance sheet all identifiable tangible and intangible assets of the target company. Intangible assets that are not meeting the identification criteria are incorporated in goodwill.

According to International and national accounting bodies such as the IASC or the FASB, purchased goodwill is considered, in the present, an intangible asset that appears as a result of the acquisition of one company by another, for a price premium.

From an economic point of view, this price premium must be justified by the estimated future additional net profits and free cash-flows that can be obtained by the acquiring company as result of investing in the target company.

The sources of these additional earnings can be divided in two categories: the unidentifiable intangible assets associated to the acquired company and, the estimated synergies between the companies implied in combination

Estimated synergies are one of the most important reasons that can explain the significant prices paid in transactions of companies. The strategic buyers are concerned with identifying and valuing the synergies that can be obtained by acquisitions of other companies

In this paper, I have tried to identify the value and types of synergies that have been identified by the management of Microsoft and determined it to pay a so huge price to take over the company LinkedIn.

On December 8, 2016, the transaction Microsoft- LinkedIn was completed for a preliminary total purchase price of \$27.0 billion (Microsoft Annual Report, 2016). As is reflected in Microsoft quarterly report (April 27, 2017) the value of the purchased goodwill is \$16.687 billion and, was assigned to Productivity and Business Processes segment.

The management of Microsoft has anticipated that exist a lot of synergies between Microsoft and LinkedIn. As is highlighted in Microsoft quarterly report (April 27, 2017) the value of the purchased goodwill was primarily attributed to increased synergies that are expected to be achieved from the integration of LinkedIn.

The announcement made by management of Microsoft with occasion of Microsoft-LinkedIn transaction (Microsoft Announce, June 13, 2016) highlights that, as result of companies 'combination, will be generated two types of operating synergies: revenue and cost synergies. It is estimated that the value of potential revenue synergies is much higher than the value of cost synergies.

As result of analysing the activities and resources of these two companies, I have identified that the Microsoft-LinkedIn combination will generate the following types of revenue synergies: cross-selling synergies, up-selling synergies and, synergies generated by extension on new service market.

Also, the value of annual cost synergies will be the result of economies of scale generated across many types of activities: sales and marketing, research & development, IT, administrative etc.

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