

MICROSOFT CORP
Form 10-Q
January 23, 2014
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended December 31, 2013

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From to

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of

incorporation or organization)
One Microsoft Way, Redmond, Washington
(Address of principal executive offices)

(425) 882-8080

91-1144442
(I.R.S. Employer

Identification No.)
98052-6399
(Zip Code)

Edgar Filing: MICROSOFT CORP - Form 10-Q

(Registrant's telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No "

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x

Accelerated filer "

Non-accelerated filer " (Do not check if a smaller reporting company)

Smaller reporting company "

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes " No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at January 17, 2014
Common Stock, \$0.00000625 par value per share	8,300,723,725 shares

Table of Contents

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2013

INDEX

	Page
PART I. <u>FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	
a) <u>Income Statements for the Three and Six Months Ended December 31, 2013 and 2012</u>	3
b) <u>Comprehensive Income Statements for the Three and Six Months Ended December 31, 2013 and 2012</u>	4
c) <u>Balance Sheets as of December 31, 2013 and June 30, 2013</u>	5
d) <u>Cash Flows Statements for the Three and Six Months Ended December 31, 2013 and 2012</u>	6
e) <u>Stockholders' Equity Statements for the Three and Six Months Ended December 31, 2013 and 2012</u>	7
f) <u>Notes to Financial Statements</u>	8
g) <u>Report of Independent Registered Public Accounting Firm</u>	31
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	51
Item 4. <u>Controls and Procedures</u>	52
PART II. <u>OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	52
Item 1A. <u>Risk Factors</u>	52
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	60
Item 6. <u>Exhibits</u>	61
<u>SIGNATURE</u>	62

Table of Contents**PART I**

Item 1

PART I. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****INCOME STATEMENTS**

(In millions, except per share amounts) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Revenue	\$ 24,519	\$ 21,456	\$ 43,048	\$ 37,464
Cost of revenue	8,284	5,692	13,398	9,860
Gross margin	16,235	15,764	29,650	27,604
Operating expenses:				
Research and development	2,748	2,528	5,515	4,988
Sales and marketing	4,283	4,309	7,587	7,254
General and administrative	1,235	1,156	2,245	2,283
Total operating expenses	8,266	7,993	15,347	14,525
Operating income	7,969	7,771	14,303	13,079
Other income (expense)	(91)	(1)	(17)	225
Income before income taxes	7,878	7,770	14,286	13,304
Provision for income taxes	1,320	1,393	2,484	2,461
Net income	\$ 6,558	\$ 6,377	\$ 11,802	\$ 10,843
Earnings per share:				
Basic	\$ 0.79	\$ 0.76	\$ 1.42	\$ 1.29
Diluted	\$ 0.78	\$ 0.76	\$ 1.40	\$ 1.28
Weighted average shares outstanding:				
Basic	8,326	8,393	8,333	8,395
Diluted	8,395	8,444	8,423	8,480
Cash dividends declared per common share	\$ 0.28	\$ 0.23	\$ 0.56	\$ 0.46

See accompanying notes.

Table of Contents**PART I**

Item 1

COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Net income	\$ 6,558	\$ 6,377	\$ 11,802	\$ 10,843
Other comprehensive income (loss):				
Net unrealized gains (losses) on derivatives (net of tax effects of \$1, \$(5), \$(2), and \$(29))	43	(9)	17	(54)
Net unrealized gains on investments (net of tax effects of \$245, \$103, \$737, and \$251)	482	192	1,434	466
Translation adjustments and other (net of tax effects of \$11, \$2, \$44 and \$92)	21	3	83	172
Other comprehensive income	546	186	1,534	584
Comprehensive income	\$ 7,104	\$ 6,563	\$ 13,336	\$ 11,427

See accompanying notes.

Table of Contents**PART I**

Item 1

BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2013	June 30, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 10,059	\$ 3,804
Short-term investments (including securities loaned of \$685 and \$579)	73,885	73,218
<hr/>		
Total cash, cash equivalents, and short-term investments	83,944	77,022
Accounts receivable, net of allowance for doubtful accounts of \$316 and \$336	15,986	17,486
Inventories	1,594	1,938
Deferred income taxes	1,328	1,632
Other	4,018	3,388
<hr/>		
Total current assets	106,870	101,466
Property and equipment, net of accumulated depreciation of \$13,686 and \$12,513	11,567	9,991
Equity and other investments	14,607	10,844
Goodwill	14,680	14,655
Intangible assets, net	2,945	3,083
Other long-term assets	2,874	2,392
<hr/>		
Total assets	\$ 153,543	\$ 142,431
<hr/>		
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	\$ 5,398	\$ 4,828
Short-term debt	300	0
Current portion of long-term debt	2,000	2,999
Accrued compensation	3,169	4,117
Income taxes	591	592
Short-term unearned revenue	17,616	20,639
Securities lending payable	748	645
Other	3,920	3,597
<hr/>		
Total current liabilities	33,742	37,417
Long-term debt	20,676	12,601
Long-term unearned revenue	1,858	1,760
Deferred income taxes	2,377	1,709
Other long-term liabilities	9,790	10,000
<hr/>		
Total liabilities	68,443	63,487

Edgar Filing: MICROSOFT CORP - Form 10-Q

Commitments and contingencies			
Stockholders' equity:			
Common stock and paid-in capital	shares authorized 24,000; outstanding 8,300 and 8,328	67,476	67,306
Retained earnings		14,347	9,895
Accumulated other comprehensive income		3,277	1,743
<hr/>			
Total stockholders' equity		85,100	78,944
<hr/>			
Total liabilities and stockholders' equity		\$ 153,543	\$ 142,431
		<hr/>	<hr/>

See accompanying notes.

Table of Contents**PART I**

Item 1

CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Operations				
Net income	\$ 6,558	\$ 6,377	\$ 11,802	\$ 10,843
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	1,261	1,009	2,215	1,719
Stock-based compensation expense	591	603	1,226	1,206
Net recognized losses on investments and derivatives	47	22	140	33
Excess tax benefits from stock-based compensation	(20)	(9)	(225)	(186)
Deferred income taxes	(176)	140	228	178
Deferral of unearned revenue	9,845	10,737	17,281	18,946
Recognition of unearned revenue	(10,578)	(10,483)	(20,255)	(19,253)
Changes in operating assets and liabilities:				
Accounts receivable	(4,875)	(4,488)	1,742	1,668
Inventories	1,029	(33)	362	(506)
Other current assets	(95)	150	(651)	(235)
Other long-term assets	(315)	(80)	(396)	(313)
Accounts payable	602	685	326	118
Other current liabilities	388	168	(867)	(1,119)
Other long-term liabilities	151	(18)	(310)	165
Net cash from operations	4,413	4,780	12,618	13,264
Financing				
Short-term debt repayments, maturities less than 90 days, net	(712)	0	0	0
Proceeds from issuance of debt	8,262	2,232	8,850	2,232
Repayments of debt	(588)	0	(1,588)	0
Common stock issued	117	145	320	562
Common stock repurchased	(2,113)	(1,658)	(4,301)	(3,290)
Common stock cash dividends paid	(2,332)	(1,933)	(4,248)	(3,609)
Excess tax benefits from stock-based compensation	20	9	225	186
Other	(39)	(16)	(39)	(16)
Net cash from (used in) financing	2,615	(1,221)	(781)	(3,935)
Investing				
Additions to property and equipment	(1,732)	(930)	(2,963)	(1,533)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(139)	(311)	(154)	(1,456)
Purchases of investments	(13,126)	(10,074)	(27,894)	(30,212)
Maturities of investments	1,451	1,989	1,798	3,248
Sales of investments	12,354	7,126	23,471	20,433

Edgar Filing: MICROSOFT CORP - Form 10-Q

Securities lending payable	167	(393)	103	(792)
Net cash used in investing	(1,025)	(2,593)	(5,639)	(10,312)
Effect of exchange rates on cash and cash equivalents	33	15	57	62
Net change in cash and cash equivalents	6,036	981	6,255	(921)
Cash and cash equivalents, beginning of period	4,023	5,036	3,804	6,938
Cash and cash equivalents, end of period	\$ 10,059	\$ 6,017	\$ 10,059	\$ 6,017

See accompanying notes.

Table of Contents**PART I**

Item 1

STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Common stock and paid-in capital				
Balance, beginning of period	\$ 67,230	\$ 66,084	\$ 67,306	\$ 65,797
Common stock issued	117	145	320	552
Common stock repurchased	(486)	(507)	(1,607)	(1,398)
Stock-based compensation expense	591	603	1,226	1,206
Stock-based compensation income tax benefits	21	5	226	172
Other, net	3	4	5	5
Balance, end of period	67,476	66,334	67,476	66,334
Retained earnings (deficit)				
Balance, beginning of period	11,680	932	9,895	(856)
Net income	6,558	6,377	11,802	10,843
Common stock cash dividends	(2,319)	(1,922)	(4,656)	(3,859)
Common stock repurchased	(1,572)	(1,151)	(2,694)	(1,892)
Balance, end of period	14,347	4,236	14,347	4,236
Accumulated other comprehensive income				
Balance, beginning of period	2,731	1,820	1,743	1,422
Other comprehensive income	546	186	1,534	584
Balance, end of period	3,277	2,006	3,277	2,006
Total stockholders' equity	\$ 85,100	\$ 72,576	\$ 85,100	\$ 72,576

See accompanying notes.

Table of Contents

PART I

Item 1

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Accounting Principles

In the opinion of management, the accompanying balance sheets and related interim statements of income, comprehensive income, cash flows, and stockholders' equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2013 Form 10-K and Form 8-K filed with the U.S. Securities and Exchange Commission on July 30, 2013 and November 26, 2013, respectively.

Principles of Consolidation

The financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments through which we are able to exercise significant influence over but do not control the investee and are not the primary beneficiary of the investee's activities are accounted for using the equity method. Investments through which we are not able to exercise significant influence over the investee and which do not have readily determinable fair values are accounted for under the cost method.

Estimates and Assumptions

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples of estimates include: loss contingencies; product warranties; the fair value of, and/or potential goodwill impairment for, our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; allowances for product returns; the market value of our inventory; and stock-based compensation forfeiture rates. Examples of assumptions include: the elements comprising a software arrangement, including the distinction between upgrades or enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

Recasting of Certain Prior Period Information

During the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. As a result of these changes, information that our chief operating decision maker regularly reviews for purposes of allocating resources and assessing performance changed. Therefore, beginning in fiscal year 2014, we are reporting our financial performance based on our new segments described in Note 16 Segment Information. We have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance during fiscal year 2014. This change impacted Note 8 Goodwill, Note 12 Unearned Revenue, and Note 16 Segment Information, with no impact on consolidated net income or cash flows.

Recent Accounting Guidance

Recently adopted accounting guidance

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance enhancing disclosure requirements about the nature of an entity's right to offset and related arrangements associated with its financial instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. In

Edgar Filing: MICROSOFT CORP - Form 10-Q

January 2013, the FASB clarified that the scope of this guidance applies to derivatives, repurchase agreements, and securities lending arrangements that are either offset or subject to an enforceable master netting arrangement, or similar agreements. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 5 Derivatives.

Table of Contents**PART I**

Item 1

In February 2013, the FASB issued guidance on disclosure requirements for items reclassified out of accumulated other comprehensive income (AOCI). This new guidance requires entities to present (either on the face of the income statement or in the notes to financial statements) the effects on the line items of the income statement for amounts reclassified out of AOCI. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 15 Accumulated Other Comprehensive Income.

Recent accounting guidance not yet adopted

In March 2013, the FASB issued guidance on a parent's accounting for the cumulative translation adjustment upon derecognition of a subsidiary or group of assets within a foreign entity. This new guidance requires that the parent release any related cumulative translation adjustment into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The new guidance will be effective for us beginning July 1, 2014. We do not anticipate material impacts on our financial statements upon adoption.

NOTE 2 EARNINGS PER SHARE

Basic earnings per share (EPS) is computed based on the weighted average number of shares of common stock outstanding during the period. Diluted EPS is computed based on the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and stock awards.

The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Net income available for common shareholders (A)	\$ 6,558	\$ 6,377	\$ 11,802	\$ 10,843
Weighted average outstanding shares of common stock (B)	8,326	8,393	8,333	8,395
Dilutive effect of stock-based awards	69	51	90	85
Common stock and common stock equivalents (C)	<u>8,395</u>	<u>8,444</u>	<u>8,423</u>	<u>8,480</u>
Earnings Per Share				
Basic (A/B)	\$ 0.79	\$ 0.76	\$ 1.42	\$ 1.29
Diluted (A/C)	\$ 0.78	\$ 0.76	\$ 1.40	\$ 1.28

Anti-dilutive stock-based awards excluded from the calculations of diluted EPS were immaterial during the periods presented.

NOTE 3 OTHER INCOME (EXPENSE)

The components of other income (expense) were as follows:

Edgar Filing: MICROSOFT CORP - Form 10-Q

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Dividends and interest income	\$ 219	\$ 166	\$ 398	\$ 325
Interest expense	(135)	(105)	(253)	(200)
Net recognized gains on investments	70	43	63	28
Net losses on derivatives	(117)	(65)	(203)	(61)
Net gains (losses) on foreign currency remeasurements	(17)	(7)	9	(36)
Other	(111)	(33)	(31)	169
Total	\$ (91)	\$ (1)	\$ (17)	\$ 225

Table of Contents**PART I**

Item 1

Following are details of net recognized gains (losses) on investments during the periods reported:

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Other-than-temporary impairments of investments	\$ (30)	\$ (40)	\$ (66)	\$ (130)
Realized gains from sales of available-for-sale securities	144	109	258	210
Realized losses from sales of available-for-sale securities	(44)	(26)	(129)	(52)
Total	\$ 70	\$ 43	\$ 63	\$ 28

NOTE 4 INVESTMENTS**Investment Components**

The components of investments, including associated derivatives but excluding held-to-maturity investments, were as follows:

(In millions)	Cost Basis	Unrealized		Recorded Basis	Cash and Cash Equivalents		Equity and Other Investments
		Gains	Losses		Short-term Investments	Investments	
December 31, 2013							
Cash	\$ 2,747	\$ 0	\$ 0	\$ 2,747	\$ 2,747	\$ 0	\$ 0
Mutual funds	766	0	0	766	766	0	0
Commercial paper	390	0	0	390	141	249	0
Certificates of deposit	979	0	0	979	771	208	0
U.S. government and agency securities	60,824	82	(85)	60,821	452	60,369	0
Foreign government bonds	8,654	92	(44)	8,702	5,169	3,533	0
Mortgage-backed securities	1,244	40	(18)	1,266	0	1,266	0
Corporate notes and bonds	7,734	233	(37)	7,930	13	7,917	0
Municipal securities	302	25	(3)	324	0	324	0
Common and preferred stock	6,783	4,792	(118)	11,457	0	0	11,457
Other investments	1,169	0	0	1,169	0	19	1,150
Total	\$ 91,592	\$ 5,264	\$ (305)	\$ 96,551	\$ 10,059	\$ 73,885	\$ 12,607

Edgar Filing: MICROSOFT CORP - Form 10-Q

(In millions)	Unrealized			Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
	Cost Basis	Gains	Unrealized Losses				
June 30, 2013							
Cash	\$ 1,967	\$ 0	\$ 0	\$ 1,967	\$ 1,967	\$ 0	\$ 0
Mutual funds	868	0	0	868	868	0	0
Commercial paper	603	0	0	603	214	389	0
Certificates of deposit	994	0	0	994	609	385	0
U.S. government and agency securities	64,934	47	(84)	64,897	146	64,751	0
Foreign government bonds	900	16	(41)	875	0	875	0
Mortgage-backed securities	1,258	43	(13)	1,288	0	1,288	0
Corporate notes and bonds	4,993	169	(40)	5,122	0	5,122	0
Municipal securities	350	36	(1)	385	0	385	0
Common and preferred stock	6,931	2,938	(281)	9,588	0	0	9,588
Other investments	1,279	0	0	1,279	0	23	1,256
Total	\$ 85,077	\$ 3,249	\$ (460)	\$ 87,866	\$ 3,804	\$ 73,218	\$ 10,844

Table of Contents**PART I**

Item 1

In addition to the investments in the table above, we also own certain corporate notes that were purchased in connection with our agreement to lend \$2.0 billion to the group that completed their acquisition of Dell on October 29, 2013. These corporate notes are classified as held-to-maturity investments and are included in equity and other investments on the balance sheet. As of December 31, 2013, the amortized cost and recorded basis of these corporate notes was \$2.0 billion, while their estimated fair value was \$1.9 billion and associated gross unrecognized holding losses were \$132 million.

As of December 31, 2013 and June 30, 2013, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were \$450 million and \$395 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

Unrealized Losses on Investments

Investments, excluding those held-to-maturity, with continuous unrealized losses for less than 12 months and 12 months or greater and their related fair values were as follows:

(In millions)	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2013						
U.S. government and agency securities	\$ 4,193	\$ (85)	\$ 0	\$ 0	\$ 4,193	\$ (85)
Foreign government bonds	741	(32)	30	(12)	771	(44)
Mortgage-backed securities	430	(14)	66	(4)	496	(18)
Corporate notes and bonds	1,494	(36)	18	(1)	1,512	(37)
Municipal securities	42	(3)	0	0	42	(3)
Common and preferred stock	590	(72)	273	(46)	863	(118)
Total	\$ 7,490	\$ (242)	\$ 387	\$ (63)	\$ 7,877	\$ (305)

(In millions)	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2013						
U.S. government and agency securities	\$ 2,208	\$ (84)	\$ 0	\$ 0	\$ 2,208	\$ (84)
Foreign government bonds	589	(18)	69	(23)	658	(41)
Mortgage-backed securities	357	(12)	39	(1)	396	(13)
Corporate notes and bonds	1,142	(38)	27	(2)	1,169	(40)
Municipal securities	44	(1)	0	0	44	(1)

Edgar Filing: MICROSOFT CORP - Form 10-Q

Common and preferred stock	1,166	(168)	409	(113)	1,575	(281)
Total	\$ 5,506	\$ (321)	\$ 544	\$ (139)	\$ 6,050	\$ (460)

As of December 31, 2013, the fair value of our held-to-maturity investments that have been in an unrecognized loss position for less than 12 months was \$1.9 billion. The associated unrealized loss was \$132 million. As of December 31, 2013, we did not hold any held-to-maturity investments that have been in an unrecognized loss position for 12 months or greater.

Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from domestic and international equities are due to market price movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of December 31, 2013.

Table of Contents**PART I**

Item 1

Debt Investment Maturities

(In millions)	Estimated	
	Cost Basis	Fair Value
December 31, 2013		
Due in one year or less	\$ 29,401	\$ 29,480
Due after one year through five years	44,372	44,505
Due after five years through 10 years	4,633	4,670
Due after 10 years	1,721	1,757
Total ^(a)	\$ 80,127	\$ 80,412

(a) Excludes held-to-maturity investments due October 31, 2023 with a cost basis and estimated fair value at December 31, 2013 of \$2.0 billion and \$1.9 billion, respectively.

NOTE 5 DERIVATIVES

We use derivative instruments to manage risks related to foreign currencies, equity prices, interest rates, and credit; to enhance investment returns; and to facilitate portfolio diversification. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the economic impact of these exposures as effectively as possible. Our derivative programs include strategies that both qualify and do not qualify for hedge accounting treatment. All notional amounts presented below are measured in U.S. dollar equivalents.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash-flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. As of December 31, 2013 and June 30, 2013, the total notional amounts of these foreign exchange contracts sold were \$4.3 billion and \$5.1 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair-value hedging instruments. As of December 31, 2013 and June 30, 2013, the total notional amounts of these foreign exchange contracts sold were \$1.8 billion and \$407 million, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of December 31, 2013, the total notional amounts of these foreign exchange contracts purchased and sold were \$4.6 billion and \$6.9 billion, respectively. As of June 30, 2013, the total notional amounts of these foreign exchange contracts purchased and sold were \$5.0 billion and \$7.9 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not

Edgar Filing: MICROSOFT CORP - Form 10-Q

designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of December 31, 2013, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$1.6 billion and \$1.6 billion, respectively, of which \$362 million and \$420 million, respectively, were designated as hedging instruments. As of June 30, 2013, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$898 million and \$1.0 billion, respectively, none of which were designated as hedging instruments.

In connection with our agreement to purchase substantially all of the Devices & Services business of Nokia Corporation (Nokia), on September 23, 2013, we provided to Nokia 1.5 billion (\$2.0 billion) of financing in the form of convertible notes, which we have recorded as short-term investments. See further discussion in Note 13 Contingencies. The total notional amount of derivatives related to the Nokia convertible notes was \$2.1 billion as of December 31, 2013. See Note 6 Fair Value Measurements for additional details.

Table of Contents

PART I

Item 1

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of December 31, 2013, the total notional amounts of fixed-interest rate contracts purchased and sold were \$3.0 billion and \$776 million, respectively. As of June 30, 2013, the total notional amounts of fixed-interest rate contracts purchased and sold were \$1.1 billion and \$809 million, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of December 31, 2013 and June 30, 2013, the total notional derivative amounts of mortgage contracts purchased were \$1.0 billion and \$1.2 billion, respectively.

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low-cost method of managing exposure to individual credit risks or groups of credit risks. As of December 31, 2013, the total notional amounts of credit contracts purchased and sold were \$506 million and \$470 million, respectively. As of June 30, 2013, the total notional amounts of credit contracts purchased and sold were \$377 million and \$501 million, respectively.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swaps, futures, and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of December 31, 2013, the total notional amounts of commodity contracts purchased and sold were \$1.3 billion and \$338 million, respectively. As of June 30, 2013, the total notional amounts of commodity contracts purchased and sold were \$1.2 billion and \$249 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain minimum liquidity of \$1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of December 31, 2013, our long-term unsecured debt rating was AAA, and cash investments were in excess of \$1.0 billion. As a result, no collateral was required to be posted.

Fair Values of Derivative Instruments

Derivative instruments are recognized as either assets or liabilities and are measured at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

For derivative instruments designated as fair-value hedges, the gains (losses) are recognized in earnings in the periods of change together with the offsetting losses (gains) on the hedged items attributed to the risk being hedged. For options designated as fair-value hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings.

Edgar Filing: MICROSOFT CORP - Form 10-Q

For derivative instruments designated as cash-flow hedges, the effective portion of the gains (losses) on the derivatives is initially reported as a component of other comprehensive income (OCI) and is subsequently recognized in earnings when the hedged exposure is recognized in earnings. For options designated as cash-flow

Table of Contents**PART I**

Item 1

hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings. Gains (losses) on derivatives representing either hedge components excluded from the assessment of effectiveness or hedge ineffectiveness are recognized in earnings.

For derivative instruments that are not designated as hedges, gains (losses) from changes in fair values are primarily recognized in other income (expense). Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are moved from OCI into other income (expense).

The following tables present the fair values of derivative instruments designated as hedging instruments (designated hedge derivatives) and not designated as hedging instruments (non-designated hedge derivatives). The fair values exclude the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

(In millions)	December 31, 2013					June 30, 2013		
	Assets			Liabilities		Assets		Liabilities
	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities	Other Long-term Liabilities	Short-term Investments	Other Current Assets	Other Current Liabilities
Non-designated Hedge Derivatives								
Foreign exchange contracts	\$ 33	\$ 81	\$ 0	\$ (67)	\$ 0	\$ 41	\$ 87	\$ (63)
Equity contracts	166	0	0	(17)	0	157	0	(9)
Interest rate contracts	19	0	0	(10)	0	18	0	(45)
Credit contracts	25	0	0	(17)	0	19	0	(17)
Commodity contracts	4	0	0	(1)	0	3	0	(1)
Total	\$ 247	\$ 81	\$ 0	\$ (112)	\$ 0	\$ 238	\$ 87	\$ (135)
Designated Hedge Derivatives								
Foreign exchange contracts	\$ 86	\$ 90	\$ 0	\$ (1)	\$ 0	\$ 9	\$ 167	\$ 0
Equity contracts	0	0	35	(45)	(26)	0	0	0
Total	\$ 86	\$ 90	\$ 35	\$ (46)	\$ (26)	\$ 9	\$ 167	\$ 0
Total gross amounts of derivatives	\$ 333	\$ 171	\$ 35	\$ (158)	\$ (26)	\$ 247	\$ 254	\$ (135)
Gross derivatives either offset or subject to an enforceable master netting agreement	\$ 187	\$ 171	\$ 35	\$ (151)	\$ (26)	\$ 105	\$ 254	\$ (97)
Gross amounts offset in the balance sheet	(63)	(52)	(35)	136	14	(72)	(9)	80
Net amounts presented in the balance sheet	\$ 124	\$ 119	\$ 0	\$ (15)	\$ (12)	\$ 33	\$ 245	\$ (17)

Edgar Filing: MICROSOFT CORP - Form 10-Q

Gross amounts not offset in the balance sheet	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Net amount	<u>\$ 124</u>	<u>\$ 119</u>	<u>\$ 0</u>	<u>\$ (15)</u>	<u>\$ (12)</u>	<u>\$ 33</u>	<u>\$ 245</u>	<u>\$ (17)</u>

See also Note 4 Investments and Note 6 Fair Value Measurements.

Table of Contents**PART I**

Item 1

Fair-Value Hedge Gains (Losses)

We recognized in other income (expense) the following gains (losses) on contracts designated as fair value hedges and their related hedged items:

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Foreign Exchange Contracts				
Derivatives	\$ 73	\$ 35	\$ 59	\$ 23
Hedged items	(74)	(35)	(61)	(21)
Total amount of ineffectiveness	\$ (1)	\$ 0	\$ (2)	\$ 2
Equity Contracts				
Derivatives	\$ (10)	\$ 0	\$ (10)	\$ 0
Hedged items	10	0	10	0
Total amount of ineffectiveness	\$ 0	\$ 0	\$ 0	\$ 0
Amount of equity contracts excluded from effectiveness assessment	\$ (26)	\$ 0	\$ (26)	\$ 0

Cash Flow Hedge Gains (Losses)

We recognized the following gains (losses) on foreign exchange contracts designated as cash flow hedges (our only cash flow hedges during the periods presented):

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Effective Portion				
Gains (losses) recognized in OCI (net of tax effects of \$2, \$7, \$0 and \$(5))	\$ 67	\$ 13	\$ 59	\$ (10)
Gains reclassified from AOCI into revenue	25	34	44	69
Amount Excluded from Effectiveness Assessment and Ineffective Portion				
Losses recognized in other income (expense)	(40)	(36)	(120)	(107)

Edgar Filing: MICROSOFT CORP - Form 10-Q

We estimate that \$82 million of net derivative gains included in OCI at December 31, 2013 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during the three and six months ended December 31, 2013.

Table of Contents**PART I**

Item 1

Non-Designated Derivative Gains (Losses)

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). These amounts are shown in the table below, with the exception of gains (losses) on derivatives presented in income statement line items other than other income (expense), which were immaterial for the periods presented. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities.

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Foreign exchange contracts	\$ 60	\$ (12)	\$ 74	\$ (25)
Equity contracts	(41)	15	(46)	17
Interest-rate contracts	(13)	1	0	19
Credit contracts	4	(2)	3	(9)
Commodity contracts	0	(45)	11	21
Total	\$ 10	\$ (43)	\$ 42	\$ 23

NOTE 6 FAIR VALUE MEASUREMENTS

We account for certain assets and liabilities at fair value. The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. We categorize each of our fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1 inputs are based upon unadjusted quoted prices for identical instruments traded in active markets. Our Level 1 non-derivative investments primarily include U.S. government securities, domestic and international equities, and actively traded mutual funds. Our Level 1 derivative assets and liabilities include those actively traded on exchanges.

Level 2 inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, credit spreads, foreign exchange rates, and forward and spot prices for currencies and commodities. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, common and preferred stock, mortgage-backed securities, U.S. agency securities, foreign government bonds, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.

Level 3 inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing

Edgar Filing: MICROSOFT CORP - Form 10-Q

models and discounted cash flow models. Our Level 3 non-derivative assets primarily comprise investments in certain corporate bonds and goodwill when it is recorded at fair value due to an impairment charge. We value the Level 3 corporate bonds using internally developed valuation models, inputs to which include interest rate curves, credit spreads, stock prices, volatilities, and probability-weighted scenarios. Unobservable inputs used in all of these models are significant to the fair values of the assets and liabilities.

We measure certain assets, including our cost and equity method investments, at fair value on a nonrecurring basis when they are deemed to be other-than-temporarily impaired. The fair values of these investments are determined based on valuation techniques using the best information available, and may include quoted market prices, market comparables, and discounted cash flow projections. An impairment charge is recorded when the cost of the investment exceeds its fair value and this condition is determined to be other-than-temporary.

Our other current financial assets and our current financial liabilities have fair values that approximate their carrying values.

Table of Contents**PART I**

Item 1

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present the fair value of our financial instruments that are measured at fair value on a recurring basis:

(In millions)				Gross Fair		Net Fair Value
	Level 1	Level 2	Level 3 ^(a)	Value	Netting ^(b)	
December 31, 2013						
Assets						
Mutual funds	\$ 766	\$ 0	\$ 0	\$ 766	\$ 0	\$ 766
Commercial paper	0	390	0	390	0	390
Certificates of deposit	0	979	0	979	0	979
U.S. government and agency securities	58,963	1,858	0	60,821	0	60,821
Foreign government bonds	354	8,261	0	8,615	0	8,615
Mortgage-backed securities	0	1,267	0	1,267	0	1,267
Corporate notes and bonds	0	5,662	2,066	7,728	0	7,728
Municipal securities	0	324	0	324	0	324
Common and preferred stock	9,544	1,487	12	11,043	0	11,043
Derivatives	13	480	46	539	(150)	389
Total	\$ 69,640	\$ 20,708	\$ 2,124	\$ 92,472	\$ (150)	\$ 92,322
Liabilities						
Derivatives and other	\$ 14	\$ 99	\$ 71	\$ 184	\$ (150)	\$ 34

(In millions)				Gross Fair		Net Fair Value
	Level 1	Level 2	Level 3	Value	Netting ^(b)	
June 30, 2013						
Assets						
Mutual funds	\$ 868	\$ 0	\$ 0	\$ 868	\$ 0	\$ 868
Commercial paper	0	603	0	603	0	603
Certificates of deposit	0	994	0	994	0	994
U.S. government and agency securities	62,237	2,664	0	64,901	0	64,901
Foreign government bonds	9	851	0	860	0	860
Mortgage-backed securities	0	1,311	0	1,311	0	1,311
Corporate notes and bonds	0	4,915	19	4,934	0	4,934
Municipal securities	0	385	0	385	0	385
Common and preferred stock	8,470	717	5	9,192	0	9,192

Edgar Filing: MICROSOFT CORP - Form 10-Q

Derivatives	12	489	0	501	(81)	420
Total	\$ 71,596	\$ 12,929	\$ 24	\$ 84,549	\$ (81)	\$ 84,468
Liabilities						
Derivatives and other	\$ 14	\$ 121	\$ 0	\$ 135	\$ (80)	\$ 55

- (a) *Level 3 assets at December 31, 2013 primarily comprised 1.5 billion principal amount of Nokia convertible notes. The valuation of these notes considers the probability of closing our purchase of Nokia's Devices & Services business as well as an analysis of market comparable transactions and management assumptions. The probability-weighted scenarios are considered significant unobservable inputs used in the fair value measurement of both the convertible notes and the embedded derivative. Significant changes in these probabilities in isolation would significantly alter the fair value measurement for both the notes and the embedded derivative.*

Table of Contents**PART I**

Item 1

(b) *These amounts represent the impact of netting derivative assets and derivative liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk.*

The following table reconciles the total Net Fair Value of assets above to the balance sheet presentation of these same assets in Note 4 Investments.

(In millions)

	December 31,	June 30,
	2013	2013
Net fair value of assets measured at fair value on a recurring basis	\$ 92,322	\$ 84,468
Cash	2,747	1,967
Common and preferred stock measured at fair value on a nonrecurring basis	450	395
Other investments measured at fair value on a nonrecurring basis	1,150	1,256
Less derivative net assets classified as other current assets	(119)	(213)
Other	1	(7)
Recorded basis of investment components ^(a)	<u>\$ 96,551</u>	<u>\$ 87,866</u>

(a) *Excludes held-to-maturity investments recorded at amortized cost and measured at fair value on a nonrecurring basis.*

Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

During the three and six months ended December 31, 2013 and 2012, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)

	December 31,	June 30,
	2013	2013
Raw materials	\$ 389	\$ 328
Work in process	80	201
Finished goods	1,125	1,409
Total	<u>\$ 1,594</u>	<u>\$ 1,938</u>

Table of Contents**PART I**

Item 1

NOTE 8 GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)		September 30,			December 31, 2013
		2013	Acquisitions	Other	
Devices and Consumer	Licensing	\$ 867	\$ 0	\$ 1	\$ 868
	Hardware	1,680	0	8	1,688
	Other	738	0	0	738
Total Devices and Consumer		\$ 3,285	\$ 0	\$ 9	\$ 3,294
Commercial	Licensing	\$ 10,071	\$ 2	\$ (13)	\$ 10,060
	Other	1,311	15	0	1,326
Total Commercial		\$ 11,382	\$ 17	\$ (13)	\$ 11,386
Total goodwill		\$ 14,667	\$ 17	\$ (4)	\$ 14,680

(In millions)		June 30,			December 31, 2013
		2013	Acquisitions	Other	
Devices and Consumer	Licensing	\$ 866	\$ 0	\$ 2	\$ 868
	Hardware	1,689	0	(1)	1,688
	Other	738	0	0	738
Total Devices and Consumer		\$ 3,293	\$ 0	\$ 1	\$ 3,294
Commercial	Licensing	\$ 10,051	\$ 2	\$ 7	\$ 10,060
	Other	1,311	15	0	1,326
Total Commercial		\$ 11,362	\$ 17	\$ 7	\$ 11,386
Total goodwill		\$ 14,655	\$ 17	\$ 8	\$ 14,680

The measurement periods for the valuation of assets acquired and liabilities assumed end as soon as information on the facts and circumstances that existed as of the acquisition dates becomes available, but do not exceed 12 months. Adjustments in purchase price allocations may require a recasting of the amounts allocated to goodwill retroactive to the periods in which the acquisitions occurred.

Edgar Filing: MICROSOFT CORP - Form 10-Q

Any change in the goodwill amounts resulting from foreign currency translations and business dispositions are presented as Other in the table above.

As discussed in Note 16 Segment Information, during the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. This resulted in a change in our operating segments and reporting units. We allocated goodwill to our new reporting units using a relative fair value approach. In addition, we completed an assessment of any potential goodwill impairment for all reporting units immediately prior to the reallocation and determined that no impairment existed.

Table of Contents**PART I**

Item 1

NOTE 9 INTANGIBLE ASSETS

The components of intangible assets, all of which are finite-lived, were as follows:

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
			December 31, 2013	June 30, 2013			
Technology-based ^(a)	\$ 3,880	\$ (2,288)	\$ 1,592	\$ 3,760	\$ (2,110)	\$ 1,650	
Marketing-related	1,348	(256)	1,092	1,348	(211)	1,137	
Contract-based	798	(675)	123	823	(688)	135	
Customer-related	373	(235)	138	380	(219)	161	
Total	\$ 6,399	\$ (3,454)	\$ 2,945	\$ 6,311	\$ (3,228)	\$ 3,083	

(a) *Technology-based intangible assets included \$165 million and \$218 million as of December 31, 2013 and June 30, 2013, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

Intangible assets amortization expense was \$166 million and \$328 million for the three and six months ended December 31, 2013, respectively, and \$198 million and \$376 million for the three and six months ended December 31, 2012, respectively. Amortization of capitalized software was \$50 million and \$96 million for the three and six months ended December 31, 2013, respectively, and \$61 million and \$101 million for the three and six months ended December 31, 2012, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held at December 31, 2013:

(In millions)

Year Ending June 30,

2014 (excluding the six months ended December 31, 2013)	\$ 338
2015	500
2016	410
2017	297
2018	259
Thereafter	1,141
Total	\$ 2,945

NOTE 10 DEBT

As of December 31, 2013, we had \$23.0 billion of issued and outstanding debt, comprising \$300 million of commercial paper and \$22.7 billion of long-term debt, including the current portion.

Short-term Debt

As of December 31, 2013, we had \$300 million of commercial paper issued and outstanding, with a weighted-average interest rate of 0.11% and maturities of 91 days. The estimated fair value of this commercial paper approximates its carrying value.

Table of Contents**PART I**

Item 1

In November 2013, we amended our existing credit agreement to increase our credit facility from \$1.3 billion to \$5.0 billion and extend the expiration date to November 14, 2018. This facility serves as a back-up for our commercial paper program. As of December 31, 2013, we were in compliance with the only financial covenant in the credit agreement, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreement. No amounts were drawn against the credit facility during any of the periods presented.

Long-term Debt

As of December 31, 2013, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$22.7 billion and \$22.6 billion, respectively. This is compared to a carrying value and estimated fair value of \$15.6 billion and \$15.8 billion, respectively, as of June 30, 2013. These estimated fair values are based on Level 2 inputs.

The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of December 31, 2013 and June 30, 2013:

Due Date	Face Value	Face Value	Stated Interest	Effective Interest
	December 31, 2013	June 30, 2013	Rate	Rate
(In millions)				
Notes				
September 27, 2013	\$ *	\$ 1,000	0.875%	1.000%
June 1, 2014	2,000	2,000	2.950%	3.049%
September 25, 2015	1,750	1,750	1.625%	1.795%
February 8, 2016	750	750	2.500%	2.642%
November 15, 2017	600	600	0.875%	1.084%
May 1, 2018	450	450	1.000%	1.106%
December 6, 2018 ^(a)	1,250	*	1.625%	1.824%
June 1, 2019	1,000	1,000	4.200%	4.379%
October 1, 2020	1,000	1,000	3.000%	3.137%
February 8, 2021	500	500	4.000%	4.082%
December 6, 2021 ^(b)	2,412	*	2.125%	2.233%
November 15, 2022	750	750	2.125%	2.239%
May 1, 2023	1,000	1,000	2.375%	2.465%
December 15, 2023 ^(a)	1,500	*	3.625%	3.726%
December 6, 2028 ^(b)	2,412	*	3.125%	3.218%
May 2, 2033 ^(c)	757	715	2.625%	2.690%
June 1, 2039	750	750	5.200%	5.240%
October 1, 2040	1,000	1,000	4.500%	4.567%
February 8, 2041	1,000	1,000	5.300%	5.361%
November 15, 2042	900	900	3.500%	3.571%
May 1, 2043	500	500	3.750%	3.829%
December 15, 2043 ^(a)	500	*	4.875%	4.918%
Total	\$ 22,781	\$ 15,665		

(a) *In December 2013, we issued \$3.3 billion of debt securities.*

(b) *In December 2013, we issued 3.5 billion of debt securities.*

(c) *In April 2013, we issued 550 million of debt securities.*

* *Not applicable.*

The notes in the table above are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. As of December 31, 2013 and June 30, 2013, the aggregate unamortized discount for our long-term debt, including the current portion, was \$105 million and \$65 million, respectively.

Table of Contents**PART I**

Item 1

NOTE 11 INCOME TAXES

Our effective tax rates were approximately 17% and 18% for the three months ended December 31, 2013 and 2012, respectively, and 17% and 18% for the six months ended December 31, 2013 and 2012, respectively. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

Tax contingencies and other tax liabilities were \$9.2 billion and \$9.4 billion as of December 31, 2013 and June 30, 2013, respectively, and were included in other long-term liabilities. While we settled a portion of the U.S. Internal Revenue Service (I.R.S.) audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, we remain under audit for these years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of December 31, 2013, the primary unresolved issue was related to transfer pricing, which could have a significant impact on our financial statements if not resolved favorably. We believe our allowances for tax contingencies are appropriate. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the remaining open issues will be resolved within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2012.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2012, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our financial statements.

NOTE 12 UNEARNED REVENUE

Unearned revenue by segment was as follows, with segments with significant balances shown separately:

(In millions)

	December 31,	June 30,
	2013	2013
Commercial Licensing	\$ 15,592	\$ 18,460
Commercial Other	2,173	2,272
Rest of the segments	1,709	1,667
Total	\$ 19,474	\$ 22,399

NOTE 13 CONTINGENCIES**Antitrust, Unfair Competition, and Overcharge Class Actions**

A large number of antitrust and unfair competition class action lawsuits were filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products between 1999 and 2005.

We obtained dismissals or reached settlements of all claims made in the United States. Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued

Edgar Filing: MICROSOFT CORP - Form 10-Q

or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. We estimate the total remaining cost of the settlements is approximately \$400 million, all of which had been accrued as of December 31, 2013.

Three similar cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In March 2010, the court in the British Columbia case certified it as a class action. In April 2011, the British Columbia Court of Appeal reversed the class certification ruling and dismissed the case, holding that indirect purchasers do not have a claim. The plaintiffs appealed the decision to the Canadian Supreme Court. In October 2013, the Supreme Court reversed and reinstated part of the British Columbia case, which is now proceeding. The other two actions were inactive pending action by the Supreme Court on the British Columbia case.

Table of Contents

PART I

Item 1

Other Antitrust Litigation and Claims

In November 2004, Novell, Inc. (Novell) filed a complaint in U.S. District Court for the District of Utah (later transferred to federal court in Maryland), asserting antitrust and unfair competition claims against us related to Novell's ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. After the trial court dismissed or granted summary judgment on a number of Novell's claims, trial of the one remaining claim took place from October to December 2011, and resulted in a mistrial. In July 2012, the trial court granted Microsoft's motion for judgment as a matter of law. Novell appealed this decision to the U.S. Court of Appeals for the Tenth Circuit, which affirmed the trial court's decision in September 2013. The Court of Appeals denied Novell's request for rehearing and en banc review.

Patent and Intellectual Property Claims

Motorola litigation

In October 2010, Microsoft filed patent infringement complaints against Motorola Mobility (Motorola) with the International Trade Commission (ITC) and in U.S. District Court in Seattle for infringement of nine Microsoft patents by Motorola's Android devices. Since then, Microsoft and Motorola have filed additional claims against each other in the ITC, in federal district courts in Seattle, Wisconsin, Florida, and California, and in courts in Germany and the United Kingdom. The nature of the claims asserted and status of individual matters are summarized below.

International Trade Commission

In May 2012, the ITC issued a limited exclusion order against Motorola on one Microsoft patent, which became effective on July 18, 2012. Microsoft appealed certain aspects of the ITC rulings adverse to Microsoft, and Motorola has appealed the ITC exclusion order, to the Court of Appeals for the Federal Circuit. In October 2013, the Court of Appeals ruled in Microsoft's favor on one additional patent (since expired) and, in December 2013, affirmed the ITC's exclusion order.

In July 2013, Microsoft filed an action in U.S. District Court in Washington, D.C. seeking an order to compel enforcement of the ITC's May 2012 import ban against infringing Motorola products by the Bureau of Customs and Border Protection (CBP), after learning that CBP had failed to fully enforce the order.

In November 2010, Motorola filed an action against Microsoft in the ITC alleging infringement of five Motorola patents by Xbox consoles and accessories and seeking an exclusion order to prohibit importation of the allegedly infringing Xbox products into the U.S. At Motorola's request, the ITC terminated its investigation as to four Motorola patents, leaving only one Motorola patent at issue. In March 2013, the administrative law judge (ALJ) ruled that there has been no violation of the remaining Motorola patent. Motorola sought ITC review of the ALJ's determination, which the ITC denied in May 2013. Motorola has appealed the ITC's decision to the U.S. Court of Appeals for the Federal Circuit.

U.S. District Court

The Seattle District Court case filed in October 2010 by Microsoft as a companion to Microsoft's ITC case against Motorola has been stayed pending the outcome of Microsoft's ITC case.

In November 2010, Microsoft sued Motorola for breach of contract in U.S. District Court in Seattle, alleging that Motorola breached its commitments to standards-setting organizations to license to Microsoft certain patents on reasonable and non-discriminatory (RAND) terms and conditions. Motorola has declared these patents essential to the implementation of the H.264 video standard and the 802.11 Wi-Fi standard. In the Motorola ITC case described above and in suits described below, Motorola or a Motorola affiliate subsequently sued Microsoft on those patents in U.S. District Courts, in the ITC, and in Germany. In February 2012, the Seattle District Court granted a partial summary judgment in favor of Microsoft ruling that (1) Motorola entered into binding contractual commitments with standards organizations committing to license its declared-essential patents on RAND terms and conditions; and (2) Microsoft is a third-party beneficiary of those commitments. After trial, the Seattle District Court set per unit royalties for Motorola's H.264 and 802.11 patents, which resulted in an immaterial Microsoft liability. In September 2013, following trial of Microsoft's breach of contract claim, a jury awarded \$14.5 million in damages to Microsoft. Motorola has

appealed.

Cases filed by Motorola in Wisconsin, California, and Florida, with the exception of one currently stayed case in Wisconsin (a companion case to Motorola's ITC action), have been transferred to the U.S District Court in Seattle.

Table of Contents

PART I

Item 1

Motorola and Microsoft both seek damages as well as injunctive relief. No trial dates have been set in any of the transferred cases, and the court has stayed these cases on agreement of the parties.

In the transferred cases, Motorola asserts 15 patents are infringed by many Microsoft products including Windows Mobile 6.5 and Windows Phone 7, Windows Marketplace, Silverlight, Windows Vista and Windows 7, Exchange Server 2003 and later, Exchange ActiveSync, Windows Live Messenger, Lync Server 2010, Outlook 2010, Office 365, SQL Server, Internet Explorer 9, Xbox, and Kinect.

In the Motorola action originally filed in California, Motorola asserts that Microsoft violated antitrust laws in connection with Microsoft's assertion of patents against Motorola that Microsoft has agreed to license to certain qualifying entities on RAND terms and conditions.

In counterclaims in the patent actions brought by Motorola, Microsoft asserts 14 patents are infringed by Motorola Android devices and certain Motorola digital video recorders.

Germany

In July 2011, Motorola filed patent infringement actions in Germany against Microsoft and several Microsoft subsidiaries.

Two patents (one now expired) are asserted by Motorola to be essential to implementation of the H.264 video standard, and Motorola alleges that H.264 capable products including Xbox 360, Windows 7, Media Player, and Internet Explorer infringe those patents. In May 2012, the court issued an injunction relating to all H.264 capable Microsoft products in Germany. However, due to orders in the separate litigation pending in Seattle, Washington described above, Motorola is enjoined from taking steps to enforce the German injunction. Microsoft has appealed the rulings of the first instance court.

Motorola asserts that one patent covers certain syncing functionality in the ActiveSync protocol employed by Windows Phone 7, Outlook Mobile, Hotmail Mobile, Exchange Online, Exchange Server, and Hotmail Server. In April 2013, the court stayed the case pending the outcome of parallel proceedings in which Microsoft is seeking to invalidate the patent. In November 2013, the Federal Patent Court invalidated the patent in relevant part. Motorola has appealed.

Microsoft may be able to mitigate the adverse impact of any injunction issued and enforced by altering its products to avoid Motorola's infringement claims.

Any damages would be determined in separate proceedings.

In lawsuits Microsoft filed in Germany in 2011 and 2012, Microsoft asserts Motorola Android devices infringe Microsoft patents and is seeking damages and injunctions. In 2012, regional courts in Germany issued injunctions on three of the patents Microsoft asserts. Motorola has appealed each of these cases. One judgment has been affirmed on appeal (and Motorola has further appealed), and the other two appeals are still pending. In actions filed separately by Motorola to invalidate these patents, the Federal Patent court in November and December 2013 held invalid two of the patents on which Microsoft had obtained injunctions. Microsoft has appealed. One of Microsoft's cases seeking an injunction is still pending in the first instance court. For the cases in which Microsoft obtained injunctions, if Motorola were to prevail following all

Edgar Filing: MICROSOFT CORP - Form 10-Q

appeals, Motorola could have a claim against Microsoft for damages caused by an erroneously granted injunction.

United Kingdom

In December 2011, Microsoft filed an action against Motorola in the High Court of Justice, Chancery Division, Patents Court, in London, England, seeking to revoke the UK part of the European patent asserted by Motorola in Germany against the ActiveSync protocol. In February 2012, Motorola counterclaimed alleging infringement of the patent and seeking damages and an injunction. A trial took place in December 2012, and the court ruled that Motorola's patent is invalid and revoked. The court also ruled that the patent, even if valid, would be licensed under the grant-back clause in Google's ActiveSync license. Motorola appealed and the appeals court affirmed the lower court's ruling in Microsoft's favor in November 2013.

Other patent and intellectual property claims

In addition to these cases, there are approximately 70 other patent infringement cases pending against Microsoft.

Table of Contents**PART I**

Item 1

Other

We also are subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

As of December 31, 2013, we had accrued aggregate liabilities of \$397 million in other current liabilities and \$115 million in other long-term liabilities for all of our legal matters that were contingencies as of that date. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately \$600 million in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.

Other Commitments

On September 2, 2013, we announced that we entered into a definitive agreement to acquire substantially all of Nokia's Devices & Services business, license Nokia's patents, and license and use Nokia's mapping services (the Agreement). Under the terms of the Agreement, we agreed to pay \$3.79 billion (approximately \$5.0 billion) to purchase substantially all of Nokia's Devices & Services business, and \$1.65 billion (approximately \$2.2 billion) to license Nokia's patents, for a total transaction price of \$5.44 billion (approximately \$7.2 billion) in cash. We intend to draw upon our overseas cash resources to fund the acquisition. In connection with the Agreement, on September 23, 2013, we provided Nokia \$1.5 billion (\$2.0 billion) of financing in the form of convertible notes, which are included in short-term investments on our balance sheet. Nokia will repay these notes from the proceeds of the acquisition upon closing. Nokia's shareholders approved the Agreement on November 19, 2013. We expect the acquisition will close in the first calendar quarter of 2014, subject to regulatory approvals and other closing conditions.

NOTE 14 STOCKHOLDERS' EQUITY**Share Repurchases**

We repurchased the following shares of common stock through our share repurchase program, during the periods presented:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Shares of common stock repurchased	53	58	100	91
Value of common stock repurchased	\$ 2,000	\$ 1,607	\$ 3,500	\$ 2,607

Excluded from this table are shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards. We repurchased all shares with cash resources. On September 16, 2013, our Board of Directors approved a \$40.0 billion share repurchase program, which replaced the share repurchase program that expired September 30, 2013. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2013, approximately \$38.0 billion remained of our \$40.0 billion share repurchase program.

Table of Contents**PART I**

Item 1

Dividends

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
(in millions)				
Fiscal Year 2014				
September 16, 2013	\$ 0.28	November 21, 2013	\$ 2,332	December 12, 2013
November 19, 2013	\$ 0.28	February 20, 2014	\$ 2,324	March 13, 2014
Fiscal Year 2013				
September 18, 2012	\$ 0.23	November 15, 2012	\$ 1,933	December 13, 2012
November 28, 2012	\$ 0.23	February 21, 2013	\$ 1,925	March 14, 2013

The estimate of the amount to be paid as a result of the November 19, 2013 declaration was included in other current liabilities as of December 31, 2013.

Table of Contents**PART I**

Item 1

NOTE 15 ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the changes in accumulated other comprehensive income by component:

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Derivatives				
Accumulated other comprehensive income balance, beginning of period	\$ 40	\$ 47	\$ 66	\$ 92
Unrealized gains (losses), net of tax effects of \$2, \$7, \$0, and \$(4)	67	13	59	(10)
Reclassification adjustments for gains included in revenue	(25)	(34)	(44)	(69)
Tax expense included in provision for income taxes	1	12	2	25
Amounts reclassified from accumulated other comprehensive income	(24)	(22)	(42)	(44)
Net current period other comprehensive income (loss)	43	(9)	17	(54)
Accumulated other comprehensive income balance, end of period	\$ 83	\$ 38	\$ 83	\$ 38
Investments				
Accumulated other comprehensive income balance, beginning of period	\$ 2,746	\$ 1,705	\$ 1,794	\$ 1,431
Unrealized gains, net of tax effects of \$270, \$118, \$760, and \$261	527	220	1,474	484
Reclassification adjustments for gains included in other income (expense)	(70)	(43)	(63)	(28)
Tax expense included in provision for income taxes	25	15	23	10
Amounts reclassified from accumulated other comprehensive income	(45)	(28)	(40)	(18)
Net current period other comprehensive income	482	192	1,434	466
Accumulated other comprehensive income balance, end of period	\$ 3,228	\$ 1,897	\$ 3,228	\$ 1,897
Translation adjustments and other				
Accumulated other comprehensive income (loss) balance, beginning of period	\$ (55)	\$ 68	\$ (117)	\$ (101)
Translation adjustments and other, net of tax effects of \$11, \$2, \$44, and \$92	21	3	83	172
Accumulated other comprehensive income (loss) balance, end of period	\$ (34)	\$ 71	\$ (34)	\$ 71
Accumulated other comprehensive income, end of period	\$ 3,277	\$ 2,006	\$ 3,277	\$ 2,006

NOTE 16 SEGMENT INFORMATION

Edgar Filing: MICROSOFT CORP - Form 10-Q

In its operation of the business, management, including our chief operating decision maker, the company's Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segment information within this note is reported on that basis.

During the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. As a result of these changes, information that our chief operating decision maker regularly reviews for purposes of allocating resources and assessing performance changed. Therefore, beginning in fiscal year 2014, we are reporting our financial performance based on our new segments; Devices and Consumer (D&C) Licensing, D&C Hardware, D&C Other, Commercial Licensing, and Commercial Other. We have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance during fiscal year 2014. Our reportable segments are described below.

Table of Contents

PART I

Item 1

Devices and Consumer

Our D&C segments develop, market, and support products and services designed to entertain and connect people, increase personal productivity, help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. Our D&C segments are:

D&C Licensing, comprising: Windows, including all original equipment manufacturer (OEM) licensing (Windows OEM) and other non-volume licensing and academic volume licensing of the Windows operating system and related software (collectively, Consumer Windows); non-volume licensing of Microsoft Office, comprising the core Office product set, for consumers (Consumer Office); Windows Phone, including related patent licensing; and certain other patent licensing revenue;

D&C Hardware, comprising: Xbox gaming and entertainment consoles and accessories, second-party and third-party video game royalties, and Xbox LIVE subscriptions (Xbox Platform); Surface; and Microsoft PC accessories; and

D&C Other, comprising: Resale, including Windows Store, Xbox LIVE transactions, and Windows Phone Store; search advertising; display advertising; Subscription, comprising Office 365 Home Premium; Studios, comprising first-party video games; our retail stores; and certain other consumer products and services not included in the categories above.

Commercial

Our Commercial segments develop, market, and support software and services designed to increase individual, team, and organizational productivity and efficiency, including simplifying everyday tasks through seamless operations across the user s hardware and software. Our Commercial segments are:

Commercial Licensing, comprising: server products, including Windows Server, Microsoft SQL Server, Visual Studio, and System Center; Windows Embedded; volume licensing of the Windows operating system, excluding academic (Commercial Windows); Microsoft Office for business, including Office, Exchange, SharePoint, and Lync (Commercial Office); Client Access Licenses, which provide access rights to certain server products (CAL); Microsoft Dynamics business solutions, excluding Dynamics CRM Online; and Skype; and

Commercial Other, comprising: Enterprise Services, including Premier Support Services and Microsoft Consulting Services; Cloud Services, comprising Office 365, excluding Office 365 Home Premium (Commercial Office 365), other Microsoft Office online offerings, Dynamics CRM Online, and Windows Azure; and certain other commercial products and online services not included in the categories above.

Revenue and cost of revenue are generally directly attributed to our segments. Certain revenue contracts are allocated among the segments based on the relative value of the underlying products and services. Cost of revenue is directly charged to the D&C Hardware segment. For the remaining segments, cost of revenue is directly charged in most cases and allocated in certain cases, generally using a relative revenue methodology.

We do not allocate operating expenses to our segments. Rather, we allocate them to our two segment groups, D&C and Commercial. Due to the integrated structure of our business, allocations of expenses are made in certain cases to incent cross-collaboration among our segment groups so that a segment group is not solely burdened by the cost of a mutually beneficial activity as we seek to deliver seamless experiences across devices, whether on premise or in the cloud.

Edgar Filing: MICROSOFT CORP - Form 10-Q

Operating expenses are attributed to our segment groups as follows:

Sales and marketing expenses are primarily recorded directly to each segment group based on identified customer segment.

Research and development expenses are primarily shared across the segment groups based on relative gross margin but are mapped directly in certain cases where the value of the expense only accrues to that segment group.

General and administrative expenses are primarily allocated based on relative gross margin. Certain corporate-level activity is not allocated to our segment groups, including costs of: legal, including expenses, settlements, and fines; information technology; human resources; corporate finance; and excise taxes.

Table of Contents**PART I**

Item 1

Segment revenue and gross margin were as follows during the periods presented:

(In millions)		Three Months Ended		Six Months Ended	
		December 31,		December 31,	
		2013	2012	2013	2012
Revenue					
Devices and Consumer	Licensing	\$ 5,384	\$ 5,703	\$ 9,727	\$ 10,381
	Hardware	4,729	2,808	6,214	3,892
	Other	1,793	1,999	3,428	3,399
	Total Devices and Consumer	\$ 11,906	\$ 10,510	\$ 19,369	\$ 17,672
Commercial	Licensing	\$ 10,888	\$ 10,135	\$ 20,482	\$ 19,080
	Other	1,780	1,389	3,383	2,637
	Total Commercial	\$ 12,668	\$ 11,524	\$ 23,865	\$ 21,717
Corporate and Other		(55)	(578)	(186)	(1,925)
Total revenue		\$ 24,519	\$ 21,456	\$ 43,048	\$ 37,464
Gross Margin					
Devices and Consumer	Licensing	\$ 4,978	\$ 5,131	\$ 8,903	\$ 9,234
	Hardware	411	762	617	1,210
	Other	431	886	783	1,248
	Total Devices and Consumer	\$ 5,820	\$ 6,779	\$ 10,303	\$ 11,692
Commercial	Licensing	\$ 10,077	\$ 9,326	\$ 18,878	\$ 17,509
	Other	415	216	690	321
	Total Commercial	\$ 10,492	\$ 9,542	\$ 19,568	\$ 17,830
Corporate and Other		(77)	(557)	(221)	(1,918)
Total gross margin		\$ 16,235	\$ 15,764	\$ 29,650	\$ 27,604

Following is operating expenses by segment group. As discussed above, we do not allocate operating expenses below cost of revenue to our segments.

(In millions)	Three Months Ended	Six Months Ended
---------------	--------------------	------------------

Edgar Filing: MICROSOFT CORP - Form 10-Q

	December 31,		December 31,	
	2013	2012	2013	2012
Devices and Consumer	\$ 3,178	\$ 3,227	\$ 5,466	\$ 5,289
Commercial	4,189	3,846	8,211	7,481
Corporate and Other	899	920	1,670	1,755
Total operating expenses	\$ 8,266	\$ 7,993	\$ 15,347	\$ 14,525

Following is operating income (loss) by segment group.

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Devices and Consumer	\$ 2,642	\$ 3,552	\$ 4,837	\$ 6,403
Commercial	6,303	5,696	11,357	10,349
Corporate and Other	(976)	(1,477)	(1,891)	(3,673)
Total operating income	\$ 7,969	\$ 7,771	\$ 14,303	\$ 13,079

Table of Contents**PART I**

Item 1

Corporate and Other operating loss includes adjustments to conform our internal accounting policies to U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP generally relate to revenue recognition, income statement classification, and depreciation.

Corporate and Other activity was as follows:

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Corporate ^(a)	\$ (892)	\$ (886)	\$ (1,667)	\$ (1,684)
Other (adjustments to U.S. GAAP):				
Revenue reconciling amounts ^(b)	(55)	(578)	(186)	(1,925)
Cost of revenue reconciling amounts	(22)	21	(35)	7
Operating expenses reconciling amounts	(7)	(34)	(3)	(71)
Total Corporate and Other	\$ (976)	\$ (1,477)	\$ (1,891)	\$ (3,673)

(a) Corporate is presented on the basis of our internal accounting policies and excludes the adjustments to U.S. GAAP that are presented separately in those line items.

(b) Revenue reconciling amounts for the three months ended December 31, 2013 included \$150 million of revenue deferrals related to sales of certain devices bundled with other products and services (Bundled Offerings), offset in part by the recognition of \$105 million of previously deferred revenue related to pre-sales of Windows 8.1 to OEMs and retailers before general availability (Windows 8.1 Pre-Sales).

Revenue reconciling amounts for the three months ended December 31, 2012 included: the recognition of \$783 million of previously deferred revenue related to pre-sales of Windows 8 to OEMs and retailers before general availability (Windows 8 Pre-Sales); a net \$161 million of revenue deferred related to sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price (the Windows Upgrade Offer); \$689 million of revenue deferred related to sales of the previous version of the Microsoft Office system with a guarantee to be upgraded to the new Office at minimal or no cost (the Office Upgrade Offer) and a net \$99 million of revenue deferred related to pre-sales of the new Office to OEMs and retailers before general availability (Office Pre-Sales)(collectively, the Office Deferral); and \$380 million of revenue deferred related to sales of video games with the right to receive specified software upgrades/enhancements (the Video Game Deferral).

Revenue reconciling amounts for the six months ended December 31, 2013 included \$150 million of revenue deferrals related to Bundled Offerings.

Revenue reconciling amounts for the six months ended December 31, 2012 includes: \$977 million of revenue deferred related to the Office Deferral; a net \$545 million of revenue deferred related to the Windows Upgrade Offer; and \$380 million of revenue deferred related to the Video Game Deferral.

Edgar Filing: MICROSOFT CORP - Form 10-Q

Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is charged to the respective segment. It is impracticable for us to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

Table of Contents

PART I

Item 1

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation) as of December 31, 2013, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the three-month and six-month periods ended December 31, 2013 and 2012. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2013, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the year then ended (not presented herein); and in our report dated July 30, 2013 (November 26, 2013 as to the effects of the retrospective adjustments described in Notes 1, 5, 10, 14, 19 and 21) we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2013 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington

January 23, 2014

Table of Contents

PART I

Item 2

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Note About Forward-Looking Statements

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections:

Management's Discussion and Analysis, and Risk Factors. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, would, will be, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. We describe risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements in Risk Factors (Part II, Item 1A of this Form 10-Q), Quantitative and Qualitative Disclosures about Market Risk (Part I, Item 3), and Management's Discussion and Analysis (Part I, Item 2). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

OVERVIEW

The following Management's Discussion and Analysis (MD&A) is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our Annual Report on Form 10-K for the year ended June 30, 2013, our Form 8-K filed on November 26, 2013, and our financial statements and accompanying Notes to Financial Statements in this Form 10-Q.

Microsoft is a technology leader focused on helping people and businesses throughout the world realize their full potential. We create technology that transforms the way people work, play, and communicate across a wide range of computing devices.

We generate revenue by developing, licensing, and supporting a wide range of software products, by offering an array of services, including cloud-based services to consumers and businesses, by designing and selling devices that integrate with our cloud-based services, and by delivering relevant online advertising to a global audience. Our most significant expenses are related to compensating employees, designing, manufacturing, marketing, and selling our products and services, and income taxes.

Industry Trends

Our industry is dynamic and highly competitive, with frequent changes in both technologies and business models. Each industry shift is an opportunity to conceive new products, new technologies, or new ideas that can further transform the industry and our business. At Microsoft, we push the boundaries of what is possible through a broad range of research and development activities that seek to identify and address the changing demands of customers, industry trends, and competitive forces.

Key Opportunities and Investments

Based on our assessment of key technology trends and our broad focus on long-term research and development of new products and services, we see significant opportunities to generate future growth.

We invest research and development resources in new products and services in these areas. The capabilities and accessibility of PCs, tablets, phones, televisions, and other devices powered by rich software platforms and applications continue to grow. With this trend, we believe the full potential of software will be seen and felt in how people use these devices and the associated services at work and in their personal lives.

Table of Contents

PART I

Item 2

Devices with end-user services

We work with an ecosystem of partners to deliver a broad spectrum of Windows devices. In some cases we build our own devices, as we have chosen to do with Xbox and Surface. Xbox One was released on November 22, 2013. Surface RT and Surface Pro were released October 26, 2012 and February 9, 2013, respectively, and Surface 2 and Surface Pro 2 were released October 22, 2013.

In all of our work with partners and on our own devices, we focus on delivering seamless services and experiences across devices. As consumer services and hardware advance, we expect they will continue to better complement one another, connecting the devices people use daily to unique communications, productivity, and entertainment services from Microsoft and our partners and developers around the world.

Windows 8 reflects this shift. Launched in October 2012, Windows 8 was designed to unite the light, thin, and convenient aspects of a tablet with the power of a PC. The Windows 8 operating system includes the Windows Store, which offers a large and growing number of applications from Microsoft and partners for both business and consumer customers. The general availability of Windows 8.1, which enables new hardware and furthers the integration with other Microsoft services, started on October 17, 2013.

Going forward, our strategy will focus on creating a family of devices and services for individuals and businesses that empower people around the globe at home, at work, and on the go, for the activities they value most. This strategy will require investment in datacenters and other infrastructure to support our devices and services, and will bring continued competition with Apple, Google, and other well-established and emerging competitors. We believe our history of powering devices such as Windows PCs and Xbox, as well as our experience delivering high-value experiences through Office and other applications, will position us for future success.

Services for the enterprise

Today, businesses face important opportunities and challenges. Enterprises are asked to deploy technology that drives business strategy forward. They decide what solutions will make employees more productive, collaborative, and satisfied, or connect with customers in new and compelling ways. They work to unlock business insights from a world of data. At the same time, they must manage and secure corporate information that employees access across a growing number of personal and corporate devices.

To address these opportunities, businesses look to our world-class business applications like Office, Exchange, SharePoint, Lync, Yammer, Microsoft Dynamics, and our business intelligence solutions. They rely on our technology to manage employee corporate identity and to protect their corporate data. And, increasingly, businesses of all sizes are looking to Microsoft to realize the benefits of the cloud.

Helping businesses move to the cloud is one of our largest opportunities. Cloud-based solutions provide customers with software, services, and content over the Internet by way of shared computing resources located in centralized data centers. The shift to the cloud is driven by three important economies of scale: larger data centers can deploy computational resources at significantly lower cost per unit than smaller ones; larger data centers can coordinate and aggregate diverse customer, geographic, and application demand patterns improving the utilization of computing, storage, and network resources; and multi-tenancy lowers application maintenance labor costs for large public clouds. Because of the improved economics, the cloud offers unique levels of elasticity and agility that enable new solutions and applications. For businesses of all sizes, the cloud creates the opportunity to focus on innovation while leaving non-differentiating activities to reliable and cost-effective providers.

We continue to design and deliver cloud solutions that allow our customers to use both the cloud and their on-premise assets however best suits their own needs. For example, a company can choose to deploy Office or Microsoft Dynamics on premise, as a cloud service, or a combination of both. With Windows Server 2012, Windows Azure, and System Center infrastructure, businesses can deploy applications in their own datacenter, a partner's datacenter, or in Microsoft's datacenter with common security, management, and administration across all environments, with the flexibility and scale they desire. These hybrid capabilities allow customers to fully harness the power of the cloud so they can achieve greater levels of efficiency and tap new areas of growth.

Table of Contents

PART I

Item 2

Our future opportunity

There are several distinct areas of technology that we are focused on driving forward. Our goal is to lead the industry in these areas over the long-term, which we expect will translate to sustained growth well into the future. We are investing significant resources in:

Developing new form factors that have increasingly natural ways to use them, including touch, gesture, and speech.

Applying machine learning to make technology more intuitive and able to act on our behalf, instead of at our command.

Building and running cloud-based services in ways that unleash new experiences and opportunities for businesses and individuals.

Establishing our Windows platform across the PC, tablet, phone, server, and additional devices, as well as cloud, to drive a thriving ecosystem of developers, unify the cross-device user experience, and increase agility when bringing new advances to market.

Delivering new high-value experiences with improvements in how people learn, work, play, and interact with one another.

We believe the breadth of our devices and services portfolio, our large, global partner and customer base, and the growing Windows ecosystem position us to be a leader in these areas.

Economic Conditions, Challenges, and Risks

The market for software, devices, and cloud-based services is dynamic and highly competitive. Some of our traditional businesses such as the Windows operating system are in a period of transition. Our competitors are developing new devices and deploy competing cloud-based services for consumers and businesses. The devices and form factors customers prefer evolve rapidly, and influence how users access services in the cloud and in some cases the user's choice of which suite of cloud-based services to use. The Windows ecosystem must continue to evolve and adapt over an extended time in pace with this changing environment. To support our strategy of offering a family of devices and services designed to empower our customers for the activities they value most, we announced a change in our organizational structure in July 2013. Through this realignment, our goal is to become more nimble, collaborative, communicative, motivated, and decisive. Even if we achieve these benefits, the investments we are making in devices and infrastructure to support our cloud-based services will increase our operating costs and may decrease our operating margins.

We prioritize our investments among the highest long-term growth opportunities. These investments require significant resources and are multi-year in nature. The products and services we bring to market may be developed internally, as part of a partnership or alliance, or through acquisition.

Our success is highly dependent on our ability to attract and retain qualified employees. We hire a mix of university and industry talent worldwide. Microsoft competes for talented individuals worldwide by offering broad customer reach, scale in resources, and competitive compensation.

Aggregate demand for our software, services, and hardware is correlated to global macroeconomic factors, which remain dynamic. See a discussion of these factors and other risks under Risk Factors (Part II, Item 1A of this Form 10-Q).

Unearned Revenue

Edgar Filing: MICROSOFT CORP - Form 10-Q

Quarterly and annual revenue may be impacted by the deferral of revenue. See the discussions within Corporate and Other below regarding:

revenue deferred on certain devices bundled with other products and services (**Bundled Offerings**);

revenue deferred on pre-sales of Windows 8.1 to original equipment manufacturers (**OEMs**) and retailers before general availability (**Windows 8.1 Pre-Sales**);

revenue deferred on sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price (the **Windows Upgrade Offer**) and pre-sales of Windows 8 to OEMs and retailers before general availability (collectively, the **Windows Deferral**);

Table of Contents

PART I

Item 2

revenue deferred on sales of the previous version of the Microsoft Office system with a guarantee to be upgraded to the new Office at minimal or no cost (the Office Upgrade Offer) and pre-sales of the new Office to OEMs and retailers before general availability (collectively, the Office Deferral); and

revenue deferred on sales of video games with the right to receive specified software upgrades/enhancements (the Video Game Deferral).

If our customers elect to license cloud-based versions of our products and services rather than licensing transaction-based products and services, the associated revenue will shift from being recognized at the time of the transaction to being recognized over the subscription period or upon consumption, as applicable.

Reportable Segments

The segment amounts included in MD&A are presented on a basis consistent with our internal management reporting. Segment information appearing in Note 16 Segment Information in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) is also presented on this basis. All differences between our internal management reporting basis and accounting principles generally accepted in the U.S. (U.S. GAAP), along with certain corporate-level and other activity, are included in Corporate and Other. Operating expenses are not allocated to our segments.

During the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. As a result of these changes, information that our chief operating decision maker regularly reviews for purposes of allocating resources and assessing performance changed. Therefore, we have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance during fiscal year 2014. Our reportable segments are described below.

Devices and Consumer (D&C)

Our D&C segments develop, market, and support products and services designed to entertain and connect people, increase personal productivity, help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. Our D&C segments are:

D&C Licensing, comprising: Windows, including all OEM licensing (Windows OEM) and other non-volume licensing and academic volume licensing of the Windows operating system and related software (collectively, Consumer Windows); non-volume licensing of Microsoft Office, comprising the core Office product set, for consumers (Consumer Office); Windows Phone, including related patent licensing; and certain other patent licensing revenue;

D&C Hardware, comprising: Xbox gaming and entertainment consoles and accessories, second-party and third-party video game royalties, and Xbox LIVE subscriptions (Xbox Platform); Surface; and Microsoft PC accessories; and

D&C Other, comprising: Resale, including Windows Store, Xbox LIVE transactions, and Windows Phone Store; search advertising; display advertising; Subscription, comprising Office 365 Home Premium; Studios, comprising first-party video games; our retail stores; and certain other consumer products and services not included in the categories above.

Commercial

Our Commercial segments develop, market, and support software and services designed to increase individual, team, and organizational productivity and efficiency, including simplifying everyday tasks through seamless operations across the user s hardware and software. Our Commercial segments are:

Commercial Licensing, comprising: server products, including Windows Server, Microsoft SQL Server, Visual Studio, and System Center; Windows Embedded; volume licensing of the Windows operating system, excluding academic (Commercial Windows); Microsoft Office for business, including Office, Exchange, SharePoint, and Lync (Commercial Office); Client Access Licenses, which provide access rights to certain server products (CAL); Microsoft Dynamics business solutions, excluding Dynamics CRM Online; and Skype; and

Commercial Other, comprising: Enterprise Services, including Premier Support Services and Microsoft Consulting Services; Cloud Services, comprising Office 365, excluding Office 365 Home Premium (Commercial Office 365), other Microsoft Office online offerings, Dynamics CRM Online, and Windows Azure; and certain other commercial products and online services not included in the categories above.

Table of ContentsPART I

Item 2

SUMMARY RESULTS OF OPERATIONS

Summary

(In millions, except percentages and per share amounts)	Three Months Ended			Six Months Ended		
	December 31,		Percentage	December 31,		Percentage
	2013	2012	Change	2013	2012	Change
Revenue	\$ 24,519	\$ 21,456	14%	\$ 43,048	\$ 37,464	15%
Operating income	\$ 7,969	\$ 7,771	3%	\$ 14,303	\$ 13,079	9%
Diluted earnings per share	\$ 0.78	\$ 0.76	3%	\$ 1.40	\$ 1.28	9%

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Revenue increased \$3.1 billion or 14%, due mainly to higher D&C Hardware and Commercial Licensing revenue.

Operating income increased \$198 million or 3%, reflecting higher revenue, offset in part by higher cost of revenue and research and development expenses. Key changes in cost of revenue and operating expenses were:

Cost of revenue increased \$2.6 billion or 46%, primarily due to higher volumes of Xbox and Surface sold, as well as higher datacenter expenses.

Research and development expenses increased \$220 million or 9%, due mainly to increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Revenue increased \$5.6 billion or 15%, primarily due to higher D&C Hardware and Commercial Licensing revenue.

Operating income increased \$1.2 billion or 9%, reflecting higher revenue, offset in part by higher cost of revenue, research and development expenses, and sales and marketing expenses. Key changes in cost of revenue and operating expenses were:

Cost of revenue increased \$3.5 billion or 36%, primarily due to higher volumes of Xbox and Surface sold, as well as higher datacenter expenses.

Research and development expenses increased \$527 million or 11%, due mainly to higher capitalization of certain costs in the prior year, as well as increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups.

Sales and marketing expenses increased \$333 million or 5%, due mainly to higher advertising costs and increased investment in our retail stores.

Table of ContentsPART I

Item 2

SEGMENT RESULTS OF OPERATIONS**Devices and Consumer**

(In millions, except percentages)	Three Months Ended		Percentage	Six Months Ended		Percentage
	December 31,		Change	December 31,		Change
	2013	2012		2013	2012	
Revenue						
Licensing	\$ 5,384	\$ 5,703	(6)%	\$ 9,727	\$ 10,381	(6)%
Hardware	4,729	2,808	68%	6,214	3,892	60%
Other	1,793	1,999	(10)%	3,428	3,399	1%
Total revenue	\$ 11,906	\$ 10,510	13%	\$ 19,369	\$ 17,672	10%
Gross Margin						
Licensing	\$ 4,978	\$ 5,131	(3)%	\$ 8,903	\$ 9,234	(4)%
Hardware	411	762	(46)%	617	1,210	(49)%
Other	431	886	(51)%	783	1,248	(37)%
Total gross margin	\$ 5,820	\$ 6,779	(14)%	\$ 10,303	\$ 11,692	(12)%

Three months ended December 31, 2013 compared with three months ended December 31, 2012

D&C revenue increased \$1.4 billion or 13%, reflecting the release of Xbox One, Surface 2, and Surface Pro 2, as well as continued adoption of other Windows-enabled devices. Consumer Office revenue was impacted by the transition of customers to Office 365 Home Premium. D&C gross margin decreased \$959 million or 14%, due mainly to the timing of the releases of new products and the shift from on-premise offerings to cloud-based offerings, offset in part by higher Windows Phone revenue. We released Xbox One, Surface 2, and Surface Pro 2 in the current year and Windows 8 and Halo 4 in the prior year.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

D&C revenue increased \$1.7 billion or 10%, reflecting the release of Xbox One, Surface 2, and Surface Pro 2, as well as continued adoption of other Windows-enabled devices. Consumer Office revenue was impacted by the transition of customers to Office 365 Home Premium. D&C gross margin decreased \$1.4 billion or 12%, due mainly to the timing of the releases of new products and the shift from on-premise offerings to cloud-based offerings, offset in part by higher Windows Phone revenue.

D&C Licensing

Three months ended December 31, 2013 compared with three months ended December 31, 2012

D&C Licensing revenue decreased \$319 million or 6%, due mainly to lower revenue from licenses of Windows and Consumer Office, offset in part by increased Windows Phone revenue. Retail and other sales of Windows declined \$264 million or 69%, due mainly to the release of

Edgar Filing: MICROSOFT CORP - Form 10-Q

Windows 8 in the prior year. Windows OEM revenue declined \$109 million or 3%, reflecting a 12% increase in OEM Pro revenue, offset by continued softness in the consumer PC market. Consumer Office revenue declined \$244 million or 24%, reflecting the transition of customers to Office 365 Home Premium as well as continued softness in the consumer PC market. Windows Phone revenue increased \$340 million or 50%, reflecting higher sales of Windows Phone licenses and an increase in mobile phone patent licensing revenue.

D&C Licensing gross margin decreased \$153 million or 3%, due to decreased revenue, offset in part by a \$166 million or 29% decrease in cost of revenue. D&C Licensing cost of revenue decreased, due mainly to a decline in traffic acquisition costs.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

D&C Licensing revenue decreased \$654 million or 6%, due mainly to lower revenue from licenses of Windows and Consumer Office, offset in part by increased Windows Phone revenue. Windows OEM revenue declined \$346 million or 5%, reflecting a 9% increase in OEM Pro revenue, offset by continued softness in the consumer PC market. Retail and other sales of Windows declined \$274 million or 54%, due mainly to the release of Windows 8 in the prior year. Consumer Office revenue declined \$473 million or 25%, reflecting the transition of customers to Office 365 Home Premium as well as continued softness in the consumer PC market. Windows Phone revenue increased \$440 million or 46%, reflecting an increase in mobile phone patent licensing revenue and higher sales of Windows Phone licenses.

Table of Contents

PART I

Item 2

D&C Licensing gross margin decreased \$331 million or 4%, due to decreased revenue, offset in part by a \$323 million or 28% decrease in cost of revenue. D&C Licensing cost of revenue decreased, due mainly to a \$223 million decline in traffic acquisition costs.

D&C Hardware

Three months ended December 31, 2013 compared with three months ended December 31, 2012

D&C Hardware revenue increased \$1.9 billion or 68%, due primarily to \$1.2 billion or 54% higher Xbox Platform revenue. Surface revenue was \$893 million for the three months ended December 31, 2013. Xbox Platform revenue increased due to the release of Xbox One. We sold 7.4 million Xbox consoles during the second quarter of fiscal 2014, compared with 5.9 million Xbox consoles during the second quarter of fiscal year 2013. Surface revenue increased due to higher number of units sold, including sales of Surface 2 and Surface Pro 2.

D&C Hardware gross margin decreased \$351 million or 46%, due to a \$2.3 billion or 111% increase in cost of revenue, offset in part by higher revenue. Xbox Platform cost of revenue increased \$1.6 billion. Surface cost of revenue was \$932 million for the three months ended December 31, 2013. Xbox Platform cost of revenue increased due mainly to higher volumes of consoles sold and additional costs associated with the release of Xbox One. Surface cost of revenue increased with higher volumes sold, including sales of Surface 2 and Surface Pro 2.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

D&C Hardware revenue increased \$2.3 billion or 60%, due primarily to \$1.2 billion or 36% higher Xbox Platform revenue. Surface revenue was \$1.3 billion for the six months ended December 31, 2013. Xbox Platform revenue increased due to the release of Xbox One. We sold 8.6 million Xbox consoles during the first half of fiscal year 2014 compared with 7.5 million Xbox consoles during the first half of fiscal year 2013. Surface revenue increased due to higher number of units sold, including sales of Surface 2 and Surface Pro 2.

D&C Hardware gross margin decreased \$593 million or 49%, due to a \$2.9 billion or 109% increase in cost of revenue, offset in part by higher revenue. Xbox Platform cost of revenue increased \$1.5 billion. Surface cost of revenue was \$1.6 billion for the six months ended December 31, 2013. Xbox Platform cost of revenue increased due mainly to higher volumes of consoles sold and additional costs associated with the release of Xbox One. Surface cost of revenue increased with higher volumes sold, including sales of Surface 2 and Surface Pro 2.

D&C Other

Three months ended December 31, 2013 compared with three months ended December 31, 2012

D&C Other revenue decreased \$206 million or 10%, due mainly to decreased revenue from first-party video games, offset in part by an increase in online advertising revenue. First-party video games revenue decreased \$291 million or 58%, due mainly to the release of Halo 4 in the second quarter of fiscal year 2013. Online advertising revenue increased \$59 million or 6%. Search advertising revenue increased 34%, due primarily to increased revenue per search resulting from ongoing improvements in ad products and higher search volume, offset in part by lower display advertising revenue, which was down 32%, due mainly to a decline in Outlook.com advertising revenue.

D&C Other gross margin decreased \$455 million or 51%, due to a \$249 million or 22% increase in cost of revenue as well as lower revenue. D&C Other cost of revenue grew, due mainly to a \$165 million or 29% increase in online advertising cost of revenue, reflecting greater investment in online infrastructure and higher traffic acquisition costs. D&C Other cost of revenue also increased due to higher resale transaction costs.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

D&C Other revenue increased \$29 million or 1%, due mainly to higher online advertising revenue, offset by a \$287 million decrease in first-party video games revenue due to the release of Halo 4 in the second quarter of fiscal year 2013. Online advertising revenue increased \$165 million or 9%. Search advertising revenue increased 40%, due primarily to increased revenue per search resulting from ongoing improvements

Edgar Filing: MICROSOFT CORP - Form 10-Q

in ad products and higher search volume, offset in part by lower display advertising revenue, which was down 31%, due mainly to a decline in Outlook.com advertising revenue.

Table of Contents**PART I**

Item 2

D&C Other gross margin decreased \$465 million or 37%, due to a \$494 million or 23% increase in cost of revenue, offset in part by higher revenue. D&C Other cost of revenue grew, due mainly to a \$265 million or 25% increase in online advertising cost of revenue, reflecting greater investment in online infrastructure and higher traffic acquisition costs. D&C Other cost of revenue also increased due to \$198 million higher resale transactions costs.

Commercial

(In millions, except percentages)	Three Months Ended		Percentage	Six Months Ended		Percentage
	December 31,		Change	December 31,		Change
	2013	2012		2013	2012	
Revenue						
Licensing	\$ 10,888	\$ 10,135	7%	\$ 20,482	\$ 19,080	7%
Other	1,780	1,389	28%	3,383	2,637	28%
Total revenue	\$ 12,668	\$ 11,524	10%	\$ 23,865	\$ 21,717	10%
Gross Margin						
Licensing	\$ 10,077	\$ 9,326	8%	\$ 18,878	\$ 17,509	8%
Other	415	216	92%	690	321	115%
Total gross margin	\$ 10,492	\$ 9,542	10%	\$ 19,568	\$ 17,830	10%

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Commercial revenue increased \$1.1 billion or 10%, reflecting growth in revenue from our on-premise licensing businesses as well as adoption by customers of our Cloud Services. Commercial gross margin increased \$950 million or 10%, in line with revenue growth.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Commercial revenue increased \$2.1 billion or 10%, reflecting growth in revenue from our on-premise licensing businesses as well as adoption by customers of our Cloud Services. Commercial gross margin increased \$1.7 billion or 10%, in line with revenue growth.

Commercial Licensing

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Commercial Licensing revenue increased \$753 million or 7%, due primarily to increased revenue from our server, CAL, and Office licenses, offset in part by the transition of customers to Commercial Office 365. Server products and Commercial Office continued their strong performance as revenue grew 11% and 5%, respectively. Our annuity and non-annuity businesses both grew in line with the increase in Commercial Licensing revenue.

Commercial Licensing gross margin increased \$751 million or 8%, due to higher revenue.

Table of Contents**PART I**

Item 2

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Commercial Licensing revenue increased \$1.4 billion or 7%, due primarily to increased revenue from our server, CAL, and Office licenses, offset in part by the transition of customers to Commercial Office 365. Server products and Commercial Office continued their strong performance as revenue grew 11% and 6%, respectively. Our annuity and non-annuity businesses both grew in line with the increase in Commercial Licensing revenue.

Commercial Licensing gross margin increased \$1.4 billion or 8%, due to higher revenue.

Commercial Other

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Commercial Other revenue increased \$391 million or 28%, due to higher Cloud Services revenue and Enterprise Services revenue. Cloud Services revenue grew \$315 million or 107%, due mainly to higher revenue from Commercial Office 365. Enterprise Services revenue grew \$76 million or 7%, due primarily to growth in Premier Support Services.

Commercial Other gross margin increased \$199 million or 92%, due to higher revenue, offset in part by a \$192 million or 16% increase in cost of revenue. The increase in cost of revenue was due mainly to higher datacenter expenses, reflecting investment in online operations infrastructure.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Commercial Other revenue increased \$746 million or 28%, due to higher Cloud Services revenue and Enterprise Services revenue. Cloud Services revenue grew \$577 million or 105%, due mainly to higher revenue from Commercial Office 365. Enterprise Services revenue grew \$169 million or 8%, due primarily to growth in Premier Support Services.

Commercial Other gross margin increased \$369 million or 115%, due to higher revenue, offset in part by a \$377 million or 16% increase in cost of revenue. The increase in cost of revenue was due mainly to higher datacenter expenses, reflecting investment in online operations infrastructure.

Corporate and Other

(In millions, except percentages)	Three Months Ended		Percentage Change	Six Months Ended		Percentage Change
	December 31,			December 31,		
	2013	2012	2013	2012		
Revenue	\$ (55)	\$ (578)	90%	\$ (186)	\$ (1,925)	90%
Gross margin	\$ (77)	\$ (557)	86%	\$ (221)	\$ (1,918)	88%

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Corporate and Other revenue comprises certain revenue deferrals, including those related to product and service upgrade offers and pre-sales of new products to OEMs prior to general availability, as well as deferrals related to certain bundled product and service offerings.

Edgar Filing: MICROSOFT CORP - Form 10-Q

Corporate and Other revenue increased \$523 million or 90%, primarily due to the timing of revenue deferrals. During the three months ended December 31, 2013, we deferred \$150 million of revenue related to Bundled Offerings, offset in part by the recognition of \$105 million of previously deferred revenue related to Windows 8.1 Pre-Sales. During the three months ended December 31, 2012, we deferred a net \$788 million and \$380 million of revenue related to the Office Deferral and Video Game Deferral, respectively, offset in part by the recognition of a net \$622 million related to the Windows Deferral.

Corporate and Other gross margin increased \$480 million or 86%, due mainly to lower revenue deferrals for the three months ended December 31, 2013.

Table of Contents**PART I**

Item 2

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Corporate and Other revenue increased \$1.7 billion or 90%, primarily due to the timing of revenue deferrals. During the six months ended December 31, 2013, we deferred \$150 million of revenue related to Bundled Offerings. During the six months ended December 31, 2012, we deferred \$977 million, a net \$545 million and \$380 million of revenue related to the Office Deferral, Windows Upgrade Offer and Video Game Deferral, respectively.

Corporate and Other gross margin increased \$1.7 billion or 88%, due mainly to lower revenue deferrals for the six months ended December 31, 2013.

COST OF REVENUE**Cost of Revenue**

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2013	2012		2013	2012	
Cost of revenue	\$ 8,284	\$ 5,692	46%	\$ 13,398	\$ 9,860	36%
As a percent of revenue	34%	27%	7ppt	31%	26%	5ppt

Cost of revenue includes: manufacturing and distribution costs for products sold, including Xbox and Surface, and programs licensed; operating costs related to customer support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our websites, and traffic acquisition costs; costs incurred to support and maintain Internet-based products and services, including datacenter costs and royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs.

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Cost of revenue increased during the three months ended December 31, 2013, primarily due to a \$1.6 billion increase in Xbox Platform cost of revenue. Surface cost of revenue was \$932 million. Datacenter costs increased \$145 million or 37%, reflecting investment in online operations infrastructure.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Cost of revenue increased during the six months ended December 31, 2013, primarily due to a \$1.5 billion increase in Xbox Platform cost of revenue. Surface cost of revenue was \$1.6 billion. Datacenter costs increased \$330 million or 44%, reflecting investment in online operations infrastructure.

OPERATING EXPENSES**Research and Development**

Edgar Filing: MICROSOFT CORP - Form 10-Q

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2013	2012		2013	2012	
Research and development	\$ 2,748	\$ 2,528	9%	\$ 5,515	\$ 4,988	11%
As a percent of revenue	11%	12%	(1)ppt	13%	13%	0ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code.

Table of Contents**PART I**

Item 2

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Research and development expenses increased during the three months ended December 31, 2013, primarily reflecting increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Research and development expenses increased during the six months ended December 31, 2013, primarily reflecting \$199 million higher capitalization of certain costs in the prior year, mainly related to Office 2013 and Windows 8, and increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups.

Sales and Marketing

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2013	2012		2013	2012	
Sales and marketing	\$ 4,283	\$ 4,309	(1)%	\$ 7,587	\$ 7,254	5%
As a percent of revenue	17%	20%	(3)ppt	18%	19%	(1)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and the costs of advertising, promotions, trade shows, seminars, and other programs.

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Sales and marketing expenses decreased slightly during the three months ended December 31, 2013, reflecting a decrease in fees paid to third-party enterprise software advisors.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Sales and marketing expenses increased \$333 million or 5% during the six months ended December 31, 2013, primarily due to higher advertising costs and increased investment in our retail stores. Advertising costs grew \$94 million or 8%, reflecting higher expenses associated with Windows Phone 8 and Surface. Retail stores expenses grew \$88 million, due mainly to the opening of new stores.

General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2013	2012		2013	2012	
General and administrative	\$ 1,235	\$ 1,156	7%	\$ 2,245	\$ 2,283	(2)%
As a percent of revenue	5%	5%	0ppt	5%	6%	(1)ppt

General and administrative expenses include payroll, employee benefits, stock-based compensation expense, severance expense, and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative personnel, certain taxes, and legal and other administrative fees.

Three months ended December 31, 2013 compared with three months ended December 31, 2012

General and administrative expenses grew \$79 million or 7% during the three months ended December 31, 2013, due mainly to costs for internal use software that were capitalized in the prior year as well as costs associated with preparing to close the acquisition and integrate Nokia Corporation's (Nokia) Devices & Services business.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

General and administrative expenses decreased slightly during the six months ended December 31, 2013, due mainly to a reduction in legal charges.

Table of ContentsPART I

Item 2

OTHER INCOME (EXPENSE)**Other Income (Expense)**

The components of other income (expense) were as follows:

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Dividends and interest income	\$ 219	\$ 166	\$ 398	\$ 325
Interest expense	(135)	(105)	(253)	(200)
Net recognized gains on investments	70	43	63	28
Net losses on derivatives	(117)	(65)	(203)	(61)
Net gains (losses) on foreign currency remeasurements	(17)	(7)	9	(36)
Other	(111)	(33)	(31)	169
Total	\$ (91)	\$ (1)	\$ (17)	\$ 225

We use derivative instruments to: manage risks related to foreign currencies, equity prices, interest rates, and credit; enhance investment returns; and facilitate portfolio diversification. Gains and losses from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of other comprehensive income (OCI) until the securities are sold or other-than-temporarily impaired, at which time the amounts are reclassified from accumulated other comprehensive income (AOCI) into other income (expense).

Three months ended December 31, 2013 compared with three months ended December 31, 2012

Dividends and interest income increased due to higher portfolio balances. Net losses on derivatives increased due to losses on equity derivatives for the three months ended December 31, 2013 as compared to gains on equity derivatives for the three months ended December 31, 2012, offset in part by lower losses on commodity derivatives in the current period compared to prior year. For the three months ended December 31, 2013, other includes recognized losses from certain joint ventures.

Six months ended December 31, 2013 compared with six months ended December 31, 2012

Net losses on derivatives increased due to losses on equity derivatives for the six months ended December 31, 2013 as compared to gains on equity derivatives for the six months ended December 31, 2012, higher losses on foreign exchange contracts, and lower gains on commodity derivatives for the six months ended December 31, 2013 compared to prior year. For the six months ended December 31, 2013, other reflects recognized losses from certain joint ventures, offset in part by a recognized gain on a divestiture. For the six months ended December 31, 2012, other reflects recognized gains on divestitures, including the gain recognized on the divestiture of our 50% share in the MSNBC joint venture.

INCOME TAXES

Our effective tax rates were approximately 17% and 18% for the three months ended December 31, 2013 and 2012, respectively, and 17% and 18% for the six months ended December 31, 2013 and 2012, respectively. Our effective tax rate was lower than the U.S. federal statutory rate

Edgar Filing: MICROSOFT CORP - Form 10-Q

primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

The current quarter's effective tax rate was lower than the prior year's second quarter effective tax rate, primarily from additional U.S. tax relief determined to be available with respect to transfer pricing developments in certain foreign tax jurisdictions, primarily Denmark, offset in part by changes in the earnings taxed at lower rates in foreign jurisdictions. The current year's effective tax rate was lower than the prior year's effective tax rate, primarily from additional U.S. tax relief determined to be available with respect to transfer pricing developments in certain foreign tax jurisdictions, primarily Denmark.

Table of Contents

PART I

Item 2

Tax contingencies and other tax liabilities were \$9.2 billion and \$9.4 billion as of December 31, 2013 and June 30, 2013, respectively, and were included in other long-term liabilities. While we settled a portion of the U.S. Internal Revenue Service (I.R.S.) audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, we remain under audit for these years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of December 31, 2013, the primary unresolved issue related to transfer pricing which could have a significant impact on our financial statements if not resolved favorably. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the remaining open issues will be resolved within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2012.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2012, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our financial statements.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled \$83.9 billion as of December 31, 2013, compared with \$77.0 billion as of June 30, 2013. Equity and other investments were \$14.6 billion as of December 31, 2013 compared to \$10.8 billion as of June 30, 2013. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of highly liquid investment grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities in order to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities.

We routinely monitor our financial exposure to both sovereign and non-sovereign borrowers and counterparties. Our gross exposures to our customers and investments in Portugal, Italy, Ireland, Greece, and Spain are individually and collectively not material.

Of the cash, cash equivalents, and short-term investments at December 31, 2013, \$75.7 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash, cash equivalents, and short-term investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was \$1.1 billion. As of December 31, 2013, approximately 75% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 4% were invested in corporate notes and bonds of U.S. companies, and approximately 2% were invested in U.S. mortgage-backed securities, all of which are denominated in U.S. dollars.

Securities lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was \$748 million as of December 31, 2013. Our average and maximum securities lending payable balances for the three months ended December 31, 2013 were \$529 million and \$893 million, respectively. Our average and maximum securities lending payable balances for the six months ended December 31, 2013 were \$562 million and \$893 million, respectively. Intra-quarter variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

Valuation

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our financial instruments. This pricing methodology applies to our Level 1 investments, such as exchange-traded mutual funds, domestic and

Edgar Filing: MICROSOFT CORP - Form 10-Q

international equities, and U.S. government securities. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly

Table of Contents**PART I**

Item 2

or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government bonds, mortgage-backed securities, and U.S. agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured at fair value on a recurring basis using unobservable inputs are an immaterial portion of our portfolio.

A majority of our investments are priced by pricing vendors and are generally Level 1 or Level 2 investments as these vendors either provide a quoted market price in an active market or use observable inputs for their pricing without applying significant adjustments. Broker pricing is used mainly when a quoted price is not available, the investment is not priced by our pricing vendors, or when a broker price is more reflective of fair values in the market in which the investment trades. Our broker-priced investments are generally classified as Level 2 investments because the broker prices these investments based on similar assets without applying significant adjustments. In addition, all of our broker-priced investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments. Our fair value processes include controls that are designed to ensure appropriate fair values are recorded. These controls include model validation, review of key model inputs, analysis of period-over-period fluctuations, and independent recalculation of prices where appropriate.

Cash Flows

Cash flows from operations decreased by \$646 million or 5%, to \$12.6 billion for the six months ended December 31, 2013, primarily due to lower revenue deferrals, partially offset by cash received from inventory. Cash used in financing decreased \$3.2 billion or 80%, to \$781 million, due mainly to a \$5.0 billion increase in proceeds from issuances of debt, net of repayments, partially offset by a \$1.0 billion increase in cash used for common stock repurchases, and a \$639 million increase in dividends paid. Cash used in investing decreased \$4.7 billion or 45%, to \$5.6 billion, due mainly to a \$3.9 billion decrease in cash used for net investment purchases, sales, and maturities, a \$1.3 billion decrease in cash used for acquisition of companies and purchases of intangible and other assets, and a \$895 million increase in cash from securities lending activities, partially offset by a \$1.4 billion increase in capital expenditures for property and equipment.

Debt

As of December 31, 2013, we had \$23.0 billion of issued and outstanding debt, comprising \$300 million of commercial paper and \$22.7 billion of long-term debt, including the current portion.

We issued debt to take advantage of favorable pricing and liquidity in the debt markets, reflecting our credit rating and the low interest rate environment. The proceeds of these issuances were or will be used for general corporate purposes, which may include, among other things, funding for working capital, capital expenditures, repurchases of capital stock, acquisitions, and repayment of existing debt.

Short-term debt

As of December 31, 2013, we had \$300 million of commercial paper issued and outstanding, with a weighted-average interest rate of 0.11% and maturities of 91 days. The estimated fair value of this commercial paper approximates its carrying value.

In November 2013, we amended our existing credit agreement to increase our credit facility from \$1.3 billion to \$5.0 billion and extend the expiration date to November 14, 2018. This facility serves as a back-up for our commercial paper program. As of December 31, 2013, we were in compliance with the only financial covenant in the credit agreement, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreement. No amounts were drawn against the credit facility during any of the periods presented.

Long-term debt

As of December 31, 2013, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$22.7 billion and \$22.6 billion, respectively. This is compared to a carrying value and estimated fair value of \$15.6 billion and \$15.8 billion, respectively, as of June 30, 2013. These estimated fair values are based on Level 2 inputs.

Table of Contents**PART I**

Item 2

The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of December 31, 2013:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate
(In millions)			
Notes			
June 1, 2014	\$ 2,000	2.950%	3.049%
September 25, 2015	1,750	1.625%	1.795%
February 8, 2016	750	2.500%	2.642%
November 15, 2017	600	0.875%	1.084%
May 1, 2018	450	1.000%	1.106%
December 6, 2018 ^(a)	1,250	1.625%	1.824%
June 1, 2019	1,000	4.200%	4.379%
October 1, 2020	1,000	3.000%	3.137%
February 8, 2021	500	4.000%	4.082%
December 6, 2021 ^(b)	2,412	2.125%	2.233%
November 15, 2022	750	2.125%	2.239%
May 1, 2023	1,000	2.375%	2.465%
December 15, 2023 ^(a)	1,500	3.625%	3.726%
December 6, 2028 ^(b)	2,412	3.125%	3.218%
May 2, 2033 ^(c)	757	2.625%	2.690%
June 1, 2039	750	5.200%	5.240%
October 1, 2040	1,000	4.500%	4.567%
February 8, 2041	1,000	5.300%	5.361%
November 15, 2042	900	3.500%	3.571%
May 1, 2043	500	3.750%	3.829%
December 15, 2043 ^(a)	500	4.875%	4.918%
Total	\$ 22,781		

(a) *In December 2013, we issued \$3.3 billion of debt securities.*

(b) *In December 2013, we issued 3.5 billion of debt securities.*

(c) *In April 2013, we issued 550 million of debt securities.*

The notes in the table above are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. As of December 31, 2013, the aggregate unamortized discount for our long-term debt, including the current portion, was \$105 million.

Unearned Revenue

Unearned revenue at December 31, 2013 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each coverage period and accounted for as subscriptions with revenue recognized ratably over the coverage period. Unearned revenue at December 31, 2013 also included payments for: post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions and prepaid points; Office 365 Home Premium subscriptions; Microsoft Dynamics business solutions products; Skype prepaid credits and subscriptions; OEM minimum commitments; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

Table of Contents**PART I**

Item 2

The following table outlines the expected future recognition of unearned revenue as of December 31, 2013:

(In millions)

Three Months Ending,

March 31, 2014	\$ 7,955
June 30, 2014	5,403
September 30, 2014	2,799
December 31, 2014	1,459
Thereafter	1,858
<hr/>	
Total	\$ 19,474

Share Repurchases

During the three months ended December 31, 2013, we repurchased 53.1 million shares of Microsoft common stock for \$2.0 billion under a \$40.0 billion share repurchase program approved by our Board of Directors on September 16, 2013. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2013, approximately \$38.0 billion remained of our \$40.0 billion share repurchase program. All repurchases were made using cash resources.

During the six months ended December 31, 2013, we repurchased 99.9 million shares of Microsoft common stock for \$3.5 billion under both the \$40.0 billion share repurchase program approved by our Board of Directors on September 16, 2013, and the share repurchase program that was announced in September 2008 and expired September 30, 2013. All repurchases were made using cash resources.

Dividends

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
(in millions)				
Fiscal Year 2014				
September 16, 2013	\$ 0.28	November 21, 2013	\$ 2,332	December 12, 2013
November 19, 2013	\$ 0.28	February 20, 2014	\$ 2,324	March 13, 2014
<hr/>				
Fiscal Year 2013				
September 18, 2012	\$ 0.23	November 15, 2012	\$ 1,933	December 13, 2012
November 28, 2012	\$ 0.23	February 21, 2013	\$ 1,925	March 14, 2013

Off-Balance Sheet Arrangements

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. In evaluating estimated losses on these indemnifications, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. These obligations did not have a material impact on our financial statements during the periods presented.

Other Planned Uses of Capital

On September 2, 2013, we announced that we entered into a definitive agreement to acquire substantially all of Nokia's Devices & Services business, license Nokia's patents, and license and use Nokia's mapping services (the Agreement). Under the terms of the Agreement, we agreed to pay 3.79 billion (approximately \$5.0 billion) to purchase substantially all of Nokia's Devices & Services business, and 1.65 billion (approximately \$2.2 billion) to license Nokia's patents, for a total transaction price of 5.44 billion (approximately \$7.2 billion) in cash. We intend to draw upon our overseas cash resources to fund the acquisition. In connection with the Agreement, on September 23,

Table of Contents

PART I

Item 2

2013, we provided Nokia 1.5 billion (\$2.0 billion) of financing in the form of convertible notes, which are included in short-term investments on our balance sheet. Nokia will repay these notes from the proceeds of the acquisition upon closing. Nokia's shareholders approved the Agreement on November 19, 2013. We expect the acquisition will close in the first calendar quarter of 2014, subject to regulatory approvals and other closing conditions.

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We expect capital expenditures to increase in coming years in support of our cloud and devices strategy. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

Liquidity

We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. As a result, as discussed above under Cash, Cash Equivalents, and Investments, the majority of our cash, cash equivalents, and short-term investments are held by foreign subsidiaries. We currently do not intend nor foresee a need to repatriate these funds. We expect existing domestic cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our domestic operating activities and cash commitments for investing and financing activities, such as regular quarterly dividends, debt repayment schedules, and material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future. In addition, we expect existing foreign cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our foreign operating activities and cash commitments for investing activities, such as material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future.

Should we require more capital in the U.S. than is generated by our operations domestically, for example to fund significant discretionary activities such as business acquisitions and share repurchases, we could elect to repatriate future earnings from foreign jurisdictions or raise capital through debt or equity issuances. These alternatives could result in higher effective tax rates, increased interest expense, or dilution of our earnings. We have borrowed funds and continue to believe we have the ability to do so at reasonable interest rates.

RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance enhancing disclosure requirements about the nature of an entity's right to offset and related arrangements associated with its financial instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. In January 2013, the FASB clarified that the scope of this guidance applies to derivatives, repurchase agreements, and securities lending arrangements that are either offset or subject to an enforceable master netting arrangement, or similar agreements. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 5 Derivatives in the Notes to Financial Statements.

In February 2013, the FASB issued guidance on disclosure requirements for items reclassified out of AOCI. This new guidance requires entities to present (either on the face of the income statement or in the notes to financial statements) the effects on the line items of the income statement for amounts reclassified out of AOCI. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 15 Accumulated Other Comprehensive Income in the Notes to Financial Statements.

Recent Accounting Guidance Not Yet Adopted

In March 2013, the FASB issued guidance on a parent's accounting for the cumulative translation adjustment upon derecognition of a subsidiary or group of assets within a foreign entity. This new guidance requires that the parent release any related cumulative translation adjustment into

Edgar Filing: MICROSOFT CORP - Form 10-Q

net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The new guidance will be effective for us beginning July 1, 2014. We do not anticipate material impacts on our financial statements upon adoption.

Table of Contents

PART I

Item 2

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us include revenue recognition, impairment of investment securities, goodwill, research and development costs, contingencies, income taxes, and inventories.

Revenue Recognition

Revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether the vendor-specific objective evidence (VSOE) of fair value exists for those elements. A portion of revenue may be recorded as unearned due to undelivered elements. Changes to the elements in a software arrangement, the ability to identify the VSOE for those elements, and the fair value of the respective elements could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. Certain volume licensing arrangements include a perpetual license for current products combined with rights to receive unspecified future versions of software products (Software Assurance) and are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period.

Software updates are evaluated on a case-by-case basis to determine whether they meet the definition of an upgrade, which may require revenue to be deferred and recognized when the upgrade is delivered, or if it is determined that implied post-contract customer support (PCS) is being provided, revenue from the arrangement is deferred and recognized over the implied PCS term. If updates are determined to not meet the definition of an upgrade, revenue is generally recognized as products are shipped or made available.

Windows 8.1 enables new hardware, furthers the integration with other Microsoft services and addresses customer issues with Windows 8, and was provided to Windows 8 customers at no additional charge. We evaluated Windows 8.1 and determined that it did not meet the definition of an upgrade and thus did not defer revenue related to this update. Windows 8.1 revenue was deferred for pre-sales of Windows 8.1 to original equipment manufacturers and retailers before general availability.

Windows 7 revenue was subject to deferral as a result of the Windows Upgrade Offer, which started June 2, 2012. The offer provided significantly discounted rights to purchase Windows 8 Pro to qualifying end-users that purchased Windows 7 PCs during the eligibility period. Microsoft was responsible for delivering Windows 8 Pro to the end customer. Accordingly, revenue related to the allocated discount for undelivered Windows 8 was deferred until it was delivered or the redemption period expired.

Microsoft Office system revenue was subject to deferral as a result of the Office Upgrade Offer, which started October 19, 2012. The Office Upgrade Offer allowed customers who purchased qualifying 2010 Microsoft Office system or Office for Mac 2011 products to receive, at no cost, a one-year subscription to Office 365 Home Premium or the equivalent version of 2013 Microsoft Office system upon general availability. Small business customers in applicable markets were also eligible for a three-month trial of Office 365 Small Business Premium. Accordingly, estimated revenue related to the undelivered 2013 Microsoft Office system and subscription services was deferred until the products and services were delivered or the redemption period expired.

Impairment of Investment Securities

We review investments quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed-income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an

Edgar Filing: MICROSOFT CORP - Form 10-Q

impairment charge is recorded to other income (expense) and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

Table of Contents

PART I

Item 2

Goodwill

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit.

Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated primarily through the use of a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital.

The estimates used to calculate the fair value of a reporting unit change from year to year based on operating results, market conditions, and other factors. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit.

Research and Development Costs

Costs incurred internally in researching and developing a computer software product are charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all software costs are capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through coding and testing. Generally, this occurs shortly before the products are released to manufacturing. The amortization of these costs is included in cost of revenue over the estimated life of the products.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial statements.

Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting literature also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial statements.

Inventories

Edgar Filing: MICROSOFT CORP - Form 10-Q

Inventories are stated at average cost, subject to the lower of cost or market. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory

Table of Contents

PART I

Item 2, 3

quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. These reviews include analysis of demand forecasts, product life cycle status, product development plans, current sales levels, pricing strategy, and component cost trends. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue. The determination of market value and the estimated volume of demand used in the lower of cost or market analysis require significant judgment.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign currency exchange rates, interest rates, credit risk, equity prices, and commodity prices. A portion of these risks is hedged, but they may impact our financial statements.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily and use hedges where practicable to offset the risks and maximize the economic effectiveness of our foreign currency positions. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar.

Interest Rate

Our fixed-income portfolio is diversified across credit sectors and maturities, consisting primarily of investment-grade securities. The credit risk and average maturity of the fixed-income portfolio is managed to achieve economic returns that correlate to certain global and domestic fixed-income indices. In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency and mortgage-backed securities.

Equity

Our equity portfolio consists of global, developed, and emerging market securities that are subject to market price risk. We manage the securities relative to certain global and domestic indices and expect their economic risk and return to correlate with these indices.

Commodity