

MICROSOFT CORP  
Form 10-Q  
April 24, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the Quarterly Period Ended March 31, 2014

**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

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**MICROSOFT CORPORATION**

(Exact name of registrant as specified in its charter)

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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)

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(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 April 17, 2014 |
|--|-------------------------------|
| Common Stock, \$0.00000625 par value per share | 8,260,411,967 shares          |

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**MICROSOFT CORPORATION**

**FORM 10-Q**

**For the Quarter Ended March 31, 2014**

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Item 1

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

| (In millions, except per share amounts) (Unaudited) | Three Months Ended<br>March 31, |           | Nine Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|--------------------------------|-----------|
|   | 2014                            | 2013      | 2014                           | 2013      |
| Revenue   | \$ 20,403                       | \$ 20,489 | \$ 63,451                      | \$ 57,953 |
| Cost of revenue                                     | 5,941                           | 4,787     | 19,339                         | 14,647    |
| Gross margin  | 14,462                          | 15,702    | 44,112                         | 43,306    |
| Operating expenses:                                 |                                 |           |                                |           |
| Research and development                            | 2,743                           | 2,640     | 8,258                          | 7,628     |
| Sales and marketing                                 | 3,542                           | 3,794     | 11,129                         | 11,048    |
| General and administrative                          | 1,203                           | 1,656     | 3,448                          | 3,939     |
| Total operating expenses                            | 7,488                           | 8,090     | 22,835                         | 22,615    |
| Operating income                                    | 6,974                           | 7,612     | 21,277                         | 20,691    |
| Other income (expense)                              | (17)                            | (9)       | (34)                           | 216       |
| Income before income taxes                          | 6,957                           | 7,603     | 21,243                         | 20,907    |
| Provision for income taxes                          | 1,297                           | 1,548     | 3,781                          | 4,009     |
| Net income  | \$ 5,660                        | \$ 6,055  | \$ 17,462                      | \$ 16,898 |
| Earnings per share:                                 |                                 |           |                                |           |
| Basic   | \$ 0.68                         | \$ 0.72   | \$ 2.10                        | \$ 2.02   |
| Diluted   | \$ 0.68                         | \$ 0.72   | \$ 2.08                        | \$ 1.99   |
| Weighted average shares outstanding:                |                                 |           |                                |           |
| Basic   | 8,284                           | 8,364     | 8,317                          | 8,385     |
| Diluted   | 8,367                           | 8,429     | 8,411                          | 8,472     |
| Cash dividends declared per common share            | \$ 0.28                         | \$ 0.23   | \$ 0.84                        | \$ 0.69   |

See accompanying notes.

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**COMPREHENSIVE INCOME STATEMENTS**

| <b>(In millions) (Unaudited)</b>  | <b>Three Months Ended<br/>March 31,</b> |             | <b>Nine Months Ended<br/>March 31,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2014</b>                             | <b>2013</b> | <b>2014</b>                            | <b>2013</b> |
| Net income  | <b>\$ 5,660</b>                         | \$ 6,055    | <b>\$ 17,462</b>                       | \$ 16,898   |
| Other comprehensive income (loss):  |   |             |  |             |
| Net unrealized gains (losses) on derivatives (net of tax effects of \$1, \$19, \$(1), and \$(10)) | <b>(31)</b>                             | 35          | <b>(14)</b>                            | (19)        |
| Net unrealized gains on investments (net of tax effects of \$37, \$150, \$774, and \$401)         | <b>68</b>                               | 278         | <b>1,502</b>                           | 744         |
| Translation adjustments and other (net of tax effects of \$9, \$(61), \$53 and \$31)              | <b>18</b>                               | (114)       | <b>101</b>                             | 58          |
| Other comprehensive income  | <b>55</b>                               | 199         | <b>1,589</b>                           | 783         |
| Comprehensive income  | <b>\$ 5,715</b>                         | \$ 6,254    | <b>\$ 19,051</b>                       | \$ 17,681   |

See accompanying notes.

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**BALANCE SHEETS****(In millions) (Unaudited)**

|  | March 31,<br>2014 | June 30,<br>2013 |
|--|-------------------|------------------|
| <b>Assets</b>  |                   |                  |
| Current assets:  |                   |                  |
| Cash and cash equivalents  | \$ 11,572         | \$ 3,804         |
| Short-term investments (including securities loaned of \$707 and \$579)          | 76,853            | 73,218           |
| <hr/>  |                   |                  |
| Total cash, cash equivalents, and short-term investments                         | 88,425            | 77,022           |
| Accounts receivable, net of allowance for doubtful accounts of \$255 and \$336   | 13,497            | 17,486           |
| Inventories  | 1,920             | 1,938            |
| Deferred income taxes  | 1,424             | 1,632            |
| Other  | 3,740             | 3,388            |
| <hr/>  |                   |                  |
| Total current assets   | 109,006           | 101,466          |
| Property and equipment, net of accumulated depreciation of \$14,441 and \$12,513 | 11,771            | 9,991            |
| Equity and other investments   | 14,792            | 10,844           |
| Goodwill   | 14,751            | 14,655           |
| Intangible assets, net   | 2,901             | 3,083            |
| Other long-term assets   | 2,898             | 2,392            |
| <hr/>  |                   |                  |
| Total assets   | \$ 156,119        | \$ 142,431       |
| <hr/>  |                   |                  |
| <b>Liabilities and stockholders equity</b>                                       |                   |                  |
| Current liabilities:   |                   |                  |
| Accounts payable   | \$ 4,583          | \$ 4,828         |
| Current portion of long-term debt  | 2,000             | 2,999            |
| Accrued compensation   | 3,887             | 4,117            |
| Income taxes   | 694               | 592              |
| Short-term unearned revenue  | 17,670            | 20,639           |
| Securities lending payable   | 794               | 645              |
| Other  | 4,275             | 3,597            |
| <hr/>  |                   |                  |
| Total current liabilities  | 33,903            | 37,417           |
| Long-term debt   | 20,679            | 12,601           |
| Long-term unearned revenue   | 1,842             | 1,760            |
| Deferred income taxes  | 2,318             | 1,709            |
| Other long-term liabilities  | 9,953             | 10,000           |
| <hr/>  |                   |                  |
| Total liabilities  | 68,695            | 63,487           |
| <hr/>  |                   |                  |
| Commitments and contingencies  |                   |                  |
| Stockholders equity:   |                   |                  |

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|  |  |                   |            |
|--|--|-------------------|------------|
| Common stock and paid-in capital           | shares authorized 24,000; outstanding <b>8,260</b> and 8,328 | <b>67,803</b>     | 67,306     |
| Retained earnings                          |  | <b>16,289</b>     | 9,895      |
| Accumulated other comprehensive income     |  | <b>3,332</b>      | 1,743      |
| <hr/>                                      |  |                   |            |
| Total stockholders' equity                 |  | <b>87,424</b>     | 78,944     |
| <hr/>                                      |  |                   |            |
| Total liabilities and stockholders' equity |  | <b>\$ 156,119</b> | \$ 142,431 |

See accompanying notes.

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## Item 1

**CASH FLOWS STATEMENTS**

| (In millions) (Unaudited)  | Three Months Ended |                | Nine Months Ended |                |
|--|--------------------|----------------|-------------------|----------------|
|  | March 31,          |                | March 31,         |                |
|  | 2014               | 2013           | 2014              | 2013           |
| <b>Operations</b>  |                    |                |                   |                |
| Net income   | \$ 5,660           | \$ 6,055       | \$ 17,462         | \$ 16,898      |
| Adjustments to reconcile net income to net cash from operations:                             |                    |                |                   |                |
| Depreciation, amortization, and other  | 1,255              | 1,053          | 3,470             | 2,772          |
| Stock-based compensation expense   | 602                | 599            | 1,828             | 1,805          |
| Net recognized losses (gains) on investments and derivatives                                 | (40)               | (52)           | 100               | (19)           |
| Excess tax benefits from stock-based compensation  | (22)               | (6)            | (247)             | (192)          |
| Deferred income taxes  | (190)              | 226            | 38                | 404            |
| Deferral of unearned revenue   | 10,175             | 9,686          | 27,456            | 28,632         |
| Recognition of unearned revenue  | (10,139)           | (11,599)       | (30,394)          | (30,852)       |
| Changes in operating assets and liabilities:   |                    |                |                   |                |
| Accounts receivable  | 2,501              | 2,191          | 4,243             | 3,859          |
| Inventories  | (324)              | (483)          | 38                | (989)          |
| Other current assets   | 340                | 139            | (311)             | (96)           |
| Other long-term assets   | (73)               | (13)           | (469)             | (326)          |
| Accounts payable   | (716)              | (67)           | (390)             | 51             |
| Other current liabilities  | 870                | 1,238          | 3                 | 119            |
| Other long-term liabilities  | 200                | 699            | (110)             | 864            |
| <b>Net cash from operations</b>  | <b>10,099</b>      | <b>9,666</b>   | <b>22,717</b>     | <b>22,930</b>  |
| <b>Financing</b>   |                    |                |                   |                |
| Proceeds from issuance of debt   | 0                  | 0              | 8,850             | 2,232          |
| Repayments of debt   | (300)              | 0              | (1,888)           | 0              |
| Common stock issued  | 141                | 203            | 461               | 765            |
| Common stock repurchased   | (1,845)            | (1,028)        | (6,146)           | (4,318)        |
| Common stock cash dividends paid   | (2,322)            | (1,925)        | (6,570)           | (5,534)        |
| Excess tax benefits from stock-based compensation  | 22                 | 6              | 247               | 192            |
| Other  | 0                  | 0              | (39)              | (16)           |
| <b>Net cash used in financing</b>  | <b>(4,304)</b>     | <b>(2,744)</b> | <b>(5,085)</b>    | <b>(6,679)</b> |
| <b>Investing</b>   |                    |                |                   |                |
| Additions to property and equipment  | (1,192)            | (930)          | (4,155)           | (2,463)        |
| Acquisition of companies, net of cash acquired, and purchases of intangible and other assets | (157)              | (108)          | (311)             | (1,564)        |
| Purchases of investments   | (21,323)           | (18,160)       | (49,217)          | (48,372)       |
| Maturities of investments  | 2,336              | 1,265          | 4,134             | 4,513          |
| Sales of investments   | 16,006             | 9,730          | 39,477            | 30,163         |
| Securities lending payable   | 46                 | 543            | 149               | (249)          |



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|   |                  |          |                  |          |
|---|------------------|----------|------------------|----------|
| Net cash used in investing                            | <b>(4,284)</b>   | (7,660)  | <b>(9,923)</b>   | (17,972) |
| Effect of exchange rates on cash and cash equivalents | <b>2</b>         | (39)     | <b>59</b>        | 23       |
| Net change in cash and cash equivalents               | <b>1,513</b>     | (777)    | <b>7,768</b>     | (1,698)  |
| Cash and cash equivalents, beginning of period        | <b>10,059</b>    | 6,017    | <b>3,804</b>     | 6,938    |
| Cash and cash equivalents, end of period              | <b>\$ 11,572</b> | \$ 5,240 | <b>\$ 11,572</b> | \$ 5,240 |

See accompanying notes.

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**STOCKHOLDERS EQUITY STATEMENTS**

| (In millions) (Unaudited)                     | Three Months Ended |           | Nine Months Ended |           |
|---|--------------------|-----------|-------------------|-----------|
|   | March 31,          |           | March 31,         |           |
|   | 2014               | 2013      | 2014              | 2013      |
| <b>Common stock and paid-in capital</b>       |                    |           |                   |           |
| Balance, beginning of period                  | \$ 67,476          | \$ 66,334 | \$ 67,306         | \$ 65,797 |
| Common stock issued                           | 141                | 203       | 461               | 755       |
| Common stock repurchased                      | (438)              | (313)     | (2,045)           | (1,711)   |
| Stock-based compensation expense              | 602                | 599       | 1,828             | 1,805     |
| Stock-based compensation income tax benefits  | 22                 | 2         | 248               | 174       |
| Other, net                                    | 0                  | 1         | 5                 | 6         |
| Balance, end of period                        | <b>67,803</b>      | 66,826    | <b>67,803</b>     | 66,826    |
| <b>Retained earnings (deficit)</b>            |                    |           |                   |           |
| Balance, beginning of period                  | 14,347             | 4,236     | 9,895             | (856)     |
| Net income                                    | 5,660              | 6,055     | 17,462            | 16,898    |
| Common stock cash dividends                   | (2,311)            | (1,919)   | (6,967)           | (5,778)   |
| Common stock repurchased                      | (1,407)            | (715)     | (4,101)           | (2,607)   |
| Balance, end of period                        | <b>16,289</b>      | 7,657     | <b>16,289</b>     | 7,657     |
| <b>Accumulated other comprehensive income</b> |                    |           |                   |           |
| Balance, beginning of period                  | 3,277              | 2,006     | 1,743             | 1,422     |
| Other comprehensive income                    | 55                 | 199       | 1,589             | 783       |
| Balance, end of period                        | <b>3,332</b>       | 2,205     | <b>3,332</b>      | 2,205     |
| Total stockholders equity                     | <b>\$ 87,424</b>   | \$ 76,688 | <b>\$ 87,424</b>  | \$ 76,688 |

See accompanying notes.

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**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, 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

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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.

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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 |          | Nine Months Ended |           |
|---|--------------------|----------|-------------------|-----------|
|   | March 31,          |          | March 31,         |           |
|   | 2014               | 2013     | 2014              | 2013      |
| Net income available for common shareholders (A)        | \$ 5,660           | \$ 6,055 | \$ 17,462         | \$ 16,898 |
| Weighted average outstanding shares of common stock (B) | 8,284              | 8,364    | 8,317             | 8,385     |
| Dilutive effect of stock-based awards                   | 83                 | 65       | 94                | 87        |
| Common stock and common stock equivalents (C)           | <b>8,367</b>       | 8,429    | <b>8,411</b>      | 8,472     |
| <b>Earnings Per Share</b>                               |                    |          |                   |           |
| Basic (A/B)   | \$ 0.68            | \$ 0.72  | \$ 2.10           | \$ 2.02   |
| Diluted (A/C)   | \$ 0.68            | \$ 0.72  | \$ 2.08           | \$ 1.99   |

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:

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| (In millions)                                 | Three Months Ended |               | Nine Months Ended |               |
|---|--------------------|---------------|-------------------|---------------|
|   | March 31,          |               | March 31,         |               |
|   | 2014               | 2013          | 2014              | 2013          |
| Dividends and interest income                 | \$ 220             | \$ 150        | \$ 618            | \$ 475        |
| Interest expense                              | (175)              | (109)         | (428)             | (309)         |
| Net recognized gains on investments           | 90                 | 57            | 153               | 85            |
| Net losses on derivatives                     | (50)               | (5)           | (253)             | (66)          |
| Net losses on foreign currency remeasurements | (30)               | (22)          | (21)              | (58)          |
| Other   | (72)               | (80)          | (103)             | 89            |
| <b>Total</b>                                  | <b>\$ (17)</b>     | <b>\$ (9)</b> | <b>\$ (34)</b>    | <b>\$ 216</b> |

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

| (In millions)   | Three Months Ended |              | Nine Months Ended |              |
|---|--------------------|--------------|-------------------|--------------|
|   | March 31,          |              | March 31,         |              |
|   | 2014               | 2013         | 2014              | 2013         |
| Other-than-temporary impairments of investments             | \$ (16)            | \$ (22)      | \$ (82)           | \$ (152)     |
| Realized gains from sales of available-for-sale securities  | 164                | 113          | 422               | 323          |
| Realized losses from sales of available-for-sale securities | (58)               | (34)         | (187)             | (86)         |
| <b>Total</b>  | <b>\$ 90</b>       | <b>\$ 57</b> | <b>\$ 153</b>     | <b>\$ 85</b> |

**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          |                   | and Cash Equivalents      | Short-term Investments |                              |
| <b>March 31, 2014</b>                 |                  |                 |                 |                   |                           |                        |                              |
| Cash                                  | \$ 2,790         | \$ 0            | \$ 0            | \$ 2,790          | \$ 2,790                  | \$ 0                   | \$ 0                         |
| Mutual funds                          | 566              | 0               | 0               | 566               | 566                       | 0                      | 0                            |
| Commercial paper                      | 5,873            | 0               | 0               | 5,873             | 5,743                     | 130                    | 0                            |
| Certificates of deposit               | 1,012            | 0               | 0               | 1,012             | 783                       | 229                    | 0                            |
| U.S. government and agency securities | 65,349           | 96              | (55)            | 65,390            | 334                       | 65,056                 | 0                            |
| Foreign government bonds              | 2,147            | 17              | (18)            | 2,146             | 818                       | 1,328                  | 0                            |
| Mortgage-backed securities            | 1,183            | 32              | (12)            | 1,203             | 0                         | 1,203                  | 0                            |
| Corporate notes and bonds             | 8,857            | 250             | (17)            | 9,090             | 538                       | 8,552                  | 0                            |
| Municipal securities                  | 290              | 36              | 0               | 326               | 0                         | 326                    | 0                            |
| Common and preferred stock            | 6,868            | 4,863           | (126)           | 11,605            | 0                         | 0                      | 11,605                       |
| Other investments                     | 1,198            | 0               | 0               | 1,198             | 0                         | 29                     | 1,169                        |
| <b>Total</b>                          | <b>\$ 96,133</b> | <b>\$ 5,294</b> | <b>\$ (228)</b> | <b>\$ 101,199</b> | <b>\$ 11,572</b>          | <b>\$ 76,853</b>       | <b>\$ 12,774</b>             |

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| (In millions)                         | Unrealized       |                 |                      | Recorded<br>Basis | Cash<br>and Cash<br>Equivalents | Short-term<br>Investments | Equity<br>and Other<br>Investments |
|---------------------------------------|------------------|-----------------|----------------------|-------------------|---------------------------------|---------------------------|------------------------------------|
|                                       | Cost Basis       | Gains           | Unrealized<br>Losses |                   |                                 |                           |                                    |
| <b>June 30, 2013</b>                  |                  |                 |                      |                   |                                 |                           |                                    |
| 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                              |
| <b>Total</b>                          | <b>\$ 85,077</b> | <b>\$ 3,249</b> | <b>\$ (460)</b>      | <b>\$ 87,866</b>  | <b>\$ 3,804</b>                 | <b>\$ 73,218</b>          | <b>\$ 10,844</b>                   |



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In addition to the investments in the table above, we also own 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 March 31, 2014, the amortized cost, recorded basis, and estimated fair value of these corporate notes was \$2.0 billion, while their associated gross unrecognized holding losses were \$42 million.

As of March 31, 2014 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 \$486 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 |
| <b>March 31, 2014</b>                 |                     |                   |                      |                   |                  |                   |
| U.S. government and agency securities | \$ 7,239            | \$ (55)           | \$ 0                 | \$ 0              | \$ 7,239         | \$ (55)           |
| Foreign government bonds              | 262                 | (9)               | 30                   | (9)               | 292              | (18)              |
| Mortgage-backed securities            | 441                 | (9)               | 64                   | (3)               | 505              | (12)              |
| Corporate notes and bonds             | 1,473               | (15)              | 33                   | (2)               | 1,506            | (17)              |
| Municipal securities                  | 24                  | 0                 | 0                    | 0                 | 24               | 0                 |
| Common and preferred stock            | 637                 | (68)              | 252                  | (58)              | 889              | (126)             |
| <b>Total</b>                          | <b>\$ 10,076</b>    | <b>\$ (156)</b>   | <b>\$ 379</b>        | <b>\$ (72)</b>    | <b>\$ 10,455</b> | <b>\$ (228)</b>   |

| (In millions)                         | Less than 12 Months |                   | 12 Months or Greater |                   | Total      |                   |
|---------------------------------------|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
|                                       | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>June 30, 2013</b>                  |                     |                   |                      |                   |            |                   |
| 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)               |
| Common and preferred stock            | 1,166               | (168)             | 409                  | (113)             | 1,575      | (281)             |

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|       |          |          |        |          |          |          |
|-------|----------|----------|--------|----------|----------|----------|
| Total | \$ 5,506 | \$ (321) | \$ 544 | \$ (139) | \$ 6,050 | \$ (460) |
|-------|----------|----------|--------|----------|----------|----------|

As of March 31, 2014, the fair value of our held-to-maturity investments that have been in an unrecognized loss position for less than 12 months was \$2.0 billion. The associated unrealized loss was \$42 million. As of March 31, 2014, 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 March 31, 2014.

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**Debt Investment Maturities**

| (In millions)                         | Estimated        |                  |
|---------------------------------------|------------------|------------------|
|                                       | Cost Basis       | Fair Value       |
| <b>March 31, 2014</b>                 |                  |                  |
| Due in one year or less               | \$ 32,425        | \$ 32,455        |
| Due after one year through five years | 46,145           | 46,301           |
| Due after five years through 10 years | 4,470            | 4,559            |
| Due after 10 years                    | 1,671            | 1,725            |
| <b>Total <sup>(a)</sup></b>           | <b>\$ 84,711</b> | <b>\$ 85,040</b> |

(a) Excludes held-to-maturity investments due October 31, 2023 with a cost basis and estimated fair value at March 31, 2014 of \$2.0 billion.

**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 March 31, 2014 and June 30, 2013, the total notional amounts of these foreign exchange contracts sold were \$5.3 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 March 31, 2014 and June 30, 2013, the total notional amounts of these foreign exchange contracts sold were \$1.2 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 March 31, 2014, the total notional amounts of these foreign exchange contracts purchased and sold were \$5.8 billion and \$11.8 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 designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging

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instruments, including puts, calls, swaps, and forwards. As of March 31, 2014, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$1.7 billion and \$2.1 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 and 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 Commitments and Contingencies. The total notional amount of derivatives related to the Nokia convertible notes was \$2.1 billion as of March 31, 2014. See Note 6 Fair Value Measurements for additional details.

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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 March 31, 2014, the total notional amounts of fixed-interest rate contracts purchased and sold were \$2.6 billion and \$938 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 March 31, 2014 and June 30, 2013, the total notional derivative amounts of mortgage contracts purchased were \$998 million 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 March 31, 2014, the total notional amounts of credit contracts purchased and sold were \$436 million and \$466 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 March 31, 2014, 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 March 31, 2014, 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.

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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 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.

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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)   | March 31, 2014         |                      |                              |                           | June 30, 2013          |                      |                           |
|---|------------------------|----------------------|------------------------------|---------------------------|------------------------|----------------------|---------------------------|
|   | Assets                 |                      | Liabilities                  |                           | Assets                 | Liabilities          |                           |
|   | Short-term Investments | Other Current Assets | Equity and Other Investments | Other Current Liabilities | Short-term Investments | Other Current Assets | Other Current Liabilities |
| <b>Non-designated Hedge Derivatives</b>   |                        |                      |                              |                           |                        |                      |                           |
| Foreign exchange contracts  | \$ 39                  | \$ 46                | \$ 0                         | \$ (78)                   | \$ 41                  | \$ 87                | \$ (63)                   |
| Equity contracts  | 190                    | 0                    | 0                            | (16)                      | 157                    | 0                    | (9)                       |
| Interest rate contracts   | 12                     | 0                    | 0                            | (9)                       | 18                     | 0                    | (45)                      |
| Credit contracts  | 21                     | 0                    | 0                            | (14)                      | 19                     | 0                    | (17)                      |
| Commodity contracts   | 3                      | 0                    | 0                            | (1)                       | 3                      | 0                    | (1)                       |
| <b>Total</b>  | <b>\$ 265</b>          | <b>\$ 46</b>         | <b>\$ 0</b>                  | <b>\$ (118)</b>           | <b>\$ 238</b>          | <b>\$ 87</b>         | <b>\$ (135)</b>           |
| <b>Designated Hedge Derivatives</b>   |                        |                      |                              |                           |                        |                      |                           |
| Foreign exchange contracts  | \$ 5                   | \$ 87                | \$ 0                         | \$ (15)                   | \$ 9                   | \$ 167               | \$ 0                      |
| Equity contracts  | 0                      | 0                    | 22                           | (95)                      | 0                      | 0                    | 0                         |
| <b>Total</b>  | <b>\$ 5</b>            | <b>\$ 87</b>         | <b>\$ 22</b>                 | <b>\$ (110)</b>           | <b>\$ 9</b>            | <b>\$ 167</b>        | <b>\$ 0</b>               |
| <b>Total gross amounts of derivatives</b>   | <b>\$ 270</b>          | <b>\$ 133</b>        | <b>\$ 22</b>                 | <b>\$ (228)</b>           | <b>\$ 247</b>          | <b>\$ 254</b>        | <b>\$ (135)</b>           |
| Gross derivatives either offset or subject to an enforceable master netting agreement | \$ 115                 | \$ 133               | \$ 22                        | \$ (226)                  | \$ 105                 | \$ 254               | \$ (97)                   |
| Gross amounts offset in the balance sheet   | (71)                   | (40)                 | (22)                         | 133                       | (72)                   | (9)                  | 80                        |
| <b>Net amounts presented in the balance sheet</b>                                     | <b>\$ 44</b>           | <b>\$ 93</b>         | <b>\$ 0</b>                  | <b>\$ (93)</b>            | <b>\$ 33</b>           | <b>\$ 245</b>        | <b>\$ (17)</b>            |
| Gross amounts not offset in the balance sheet   | 0                      | 0                    | 0                            | 0                         | 0                      | 0                    | 0                         |
| <b>Net amount</b>   | <b>\$ 44</b>           | <b>\$ 93</b>         | <b>\$ 0</b>                  | <b>\$ (93)</b>            | <b>\$ 33</b>           | <b>\$ 245</b>        | <b>\$ (17)</b>            |

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



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**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 |        | Nine Months Ended |       |
|---|--------------------|--------|-------------------|-------|
|   | March 31,          |        | March 31,         |       |
|   | 2014               | 2013   | 2014              | 2013  |
| <b>Foreign Exchange Contracts</b>                                 |                    |        |                   |       |
| Derivatives   | \$ (51)            | \$ 45  | \$ 8              | \$ 68 |
| Hedged items  | 48                 | (47)   | (13)              | (68)  |
| Total amount of ineffectiveness                                   | \$ (3)             | \$ (2) | \$ (5)            | \$ 0  |
| <b>Equity Contracts</b>   |                    |        |                   |       |
| Derivatives   | \$ (44)            | \$ 0   | \$ (54)           | \$ 0  |
| Hedged items  | 44                 | 0      | 54                | 0     |
| Total amount of ineffectiveness                                   | \$ 0               | \$ 0   | \$ 0              | \$ 0  |
| Amount of equity contracts excluded from effectiveness assessment | \$ 7               | \$ 0   | \$ (19)           | \$ 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 |       | Nine Months Ended |       |
|--|--------------------|-------|-------------------|-------|
|  | March 31,          |       | March 31,         |       |
|  | 2014               | 2013  | 2014              | 2013  |
| <b>Effective Portion</b>   |                    |       |                   |       |
| Gains (losses) recognized in OCI (net of tax effects of \$3, \$36, \$3 and \$31) | \$ (2)             | \$ 66 | \$ 57             | \$ 56 |
| Gains reclassified from AOCI into revenue  | 31                 | 47    | 75                | 116   |
| <b>Amount Excluded from Effectiveness Assessment and Ineffective Portion</b>     |                    |       |                   |       |
| Losses recognized in other income (expense)                                      | (53)               | (27)  | (173)             | (134) |

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We estimate that \$53 million of net derivative gains included in AOCI at March 31, 2014 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 nine months ended March 31, 2014.

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**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 |         | Nine Months Ended |         |
|----------------------------|--------------------|---------|-------------------|---------|
|                            | March 31,          |         | March 31,         |         |
|                            | 2014               | 2013    | 2014              | 2013    |
| Foreign exchange contracts | \$ (68)            | \$ (25) | \$ 6              | \$ (50) |
| Equity contracts           | (6)                | 8       | (52)              | 25      |
| Interest-rate contracts    | 12                 | (1)     | 12                | 18      |
| Credit contracts           | 0                  | 10      | 3                 | 1       |
| Commodity contracts        | 64                 | (5)     | 75                | 16      |
| Total                      | \$ 2               | \$ (13) | \$ 44             | \$ 10   |

**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

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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.

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**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 <sup>(a)</sup> | Value            | Netting <sup>(b)</sup> |                  |
| <b>March 31, 2014</b>                 |                  |                  |                        |                  |                        |                  |
| <b>Assets</b>                         |                  |                  |                        |                  |                        |                  |
| Mutual funds                          | \$ 566           | \$ 0             | \$ 0                   | \$ 566           | \$ 0                   | \$ 566           |
| Commercial paper                      | 0                | 5,873            | 0                      | 5,873            | 0                      | 5,873            |
| Certificates of deposit               | 0                | 1,012            | 0                      | 1,012            | 0                      | 1,012            |
| U.S. government and agency securities | 64,199           | 1,187            | 0                      | 65,386           | 0                      | 65,386           |
| Foreign government bonds              | 106              | 2,051            | 0                      | 2,157            | 0                      | 2,157            |
| Mortgage-backed securities            | 0                | 1,207            | 0                      | 1,207            | 0                      | 1,207            |
| Corporate notes and bonds             | 0                | 6,853            | 2,063                  | 8,916            | 0                      | 8,916            |
| Municipal securities                  | 0                | 326              | 0                      | 326              | 0                      | 326              |
| Common and preferred stock            | 9,470            | 1,639            | 11                     | 11,120           | 0                      | 11,120           |
| Derivatives                           | 7                | 391              | 27                     | 425              | (133)                  | 292              |
| <b>Total</b>                          | <b>\$ 74,348</b> | <b>\$ 20,539</b> | <b>\$ 2,101</b>        | <b>\$ 96,988</b> | <b>\$ (133)</b>        | <b>\$ 96,855</b> |
| <b>Liabilities</b>                    |                  |                  |                        |                  |                        |                  |
| Derivatives and other                 | \$ 5             | \$ 128           | \$ 95                  | \$ 228           | \$ (133)               | \$ 95            |

| (In millions)                         |         |         |         | Gross Fair |                        | Net Fair Value |
|---------------------------------------|---------|---------|---------|------------|------------------------|----------------|
|                                       | Level 1 | Level 2 | Level 3 | Value      | Netting <sup>(b)</sup> |                |
| <b>June 30, 2013</b>                  |         |         |         |            |                        |                |
| <b>Assets</b>                         |         |         |         |            |                        |                |
| 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          |

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

- (a) *Level 3 assets at March 31, 2014 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 and 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. The changes in fair value of the Nokia convertible notes have been immaterial since the date the notes were acquired.*

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(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)

|   | March 31,<br>2014 | June 30,<br>2013 |
|---|-------------------|------------------|
| Net fair value of assets measured at fair value on a recurring basis      | \$ 96,855         | \$ 84,468        |
| Cash  | 2,790             | 1,967            |
| Common and preferred stock measured at fair value on a nonrecurring basis | 486               | 395              |
| Other investments measured at fair value on a nonrecurring basis          | 1,169             | 1,256            |
| Less derivative net assets classified as other current assets             | (93)              | (213)            |
| Other   | (8)               | (7)              |
| Recorded basis of investment components <sup>(a)</sup>                    | <u>\$ 101,199</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 nine months ended March 31, 2014 and 2013, 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)

|                 | March 31,<br>2014 | June 30,<br>2013 |
|-----------------|-------------------|------------------|
| Raw materials   | \$ 508            | \$ 328           |
| Work in process | 60                | 201              |
| Finished goods  | 1,352             | 1,409            |
| Total           | <u>\$ 1,920</u>   | <u>\$ 1,938</u>  |





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**NOTE 8 GOODWILL**

Changes in the carrying amount of goodwill were as follows:

| (In millions)              |           | December 31, |              |       | March 31, |
|----------------------------|-----------|--------------|--------------|-------|-----------|
|                            |           | 2013         | Acquisitions | Other | 2014      |
| Devices and Consumer       | Licensing | \$ 868       | \$ 0         | \$ 0  | \$ 868    |
|                            | Hardware  | 1,688        | 0            | 2     | 1,690     |
|                            | Other     | 738          | 0            | 0     | 738       |
| Total Devices and Consumer |           | \$ 3,294     | \$ 0         | \$ 2  | \$ 3,296  |
| Commercial                 | Licensing | \$ 10,060    | \$ 0         | \$ 15 | \$ 10,075 |
|                            | Other     | 1,326        | 54           | 0     | 1,380     |
| Total Commercial           |           | \$ 11,386    | \$ 54        | \$ 15 | 11,455    |
| Total goodwill             |           | \$ 14,680    | \$ 54        | \$ 17 | \$ 14,751 |

| (In millions)              |           | June 30,  |              |       | March 31, |
|----------------------------|-----------|-----------|--------------|-------|-----------|
|                            |           | 2013      | Acquisitions | Other | 2014      |
| Devices and Consumer       | Licensing | \$ 866    | \$ 0         | \$ 2  | \$ 868    |
|                            | Hardware  | 1,689     | 0            | 1     | 1,690     |
|                            | Other     | 738       | 0            | 0     | 738       |
| Total Devices and Consumer |           | \$ 3,293  | \$ 0         | \$ 3  | \$ 3,296  |
| Commercial                 | Licensing | \$ 10,051 | \$ 2         | \$ 22 | \$ 10,075 |
|                            | Other     | 1,311     | 69           | 0     | 1,380     |
| Total Commercial           |           | \$ 11,362 | \$ 71        | \$ 22 | 11,455    |
| Total goodwill             |           | \$ 14,655 | \$ 71        | \$ 25 | \$ 14,751 |

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.

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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.

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**NOTE 9 INTANGIBLE ASSETS**

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

| (In millions)                   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net               |                  | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
|---------------------------------|-----------------------------|-----------------------------|-------------------|------------------|-----------------------------|---------------------------|
|                                 |                             |                             | March 31,<br>2014 | June 30,<br>2013 |                             |                           |
| Technology-based <sup>(a)</sup> | \$ 3,987                    | \$ (2,421)                  | \$ 1,566          | \$ 3,760         | \$ (2,110)                  | \$ 1,650                  |
| Marketing-related               | 1,365                       | (279)                       | 1,086             | 1,348            | (211)                       | 1,137                     |
| Contract-based                  | 799                         | (680)                       | 119               | 823              | (688)                       | 135                       |
| Customer-related                | 377                         | (247)                       | 130               | 380              | (219)                       | 161                       |
| <b>Total</b>                    | <b>\$ 6,528</b>             | <b>\$ (3,627)</b>           | <b>\$ 2,901</b>   | <b>\$ 6,311</b>  | <b>\$ (3,228)</b>           | <b>\$ 3,083</b>           |

(a) *Technology-based intangible assets included \$147 million and \$218 million as of March 31, 2014 and June 30, 2013, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

Intangible assets amortization expense was \$170 million and \$498 million for the three and nine months ended March 31, 2014, respectively, and \$187 million and \$563 million for the three and nine months ended March 31, 2013 respectively. Amortization of capitalized software was \$50 million and \$146 million for the three and nine months ended March 31, 2014, respectively, and \$52 million and \$153 million for the three and nine months ended March 31, 2013, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held at March 31, 2014:

(In millions)

**Year Ending June 30,**

|   |                 |
|---|-----------------|
| 2014 (excluding the nine months ended March 31, 2014) | \$ 177          |
| 2015  | 525             |
| 2016  | 434             |
| 2017  | 310             |
| 2018  | 270             |
| Thereafter  | 1,185           |
| <b>Total</b>  | <b>\$ 2,901</b> |

NOTE 10 DEBT

**Long-term Debt**

As of March 31, 2014, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$22.7 billion and \$23.2 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.

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The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of March 31, 2014 and June 30, 2013:

| Due Date                         | Face Value       | Face Value       | Stated Interest | Effective Interest |
|----------------------------------|------------------|------------------|-----------------|--------------------|
|                                  | March 31, 2014   | June 30, 2013    | Rate            | Rate               |
| (In millions)                    |                  |                  |                 |                    |
| <b>Notes</b>                     |                  |                  |                 |                    |
| 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 <sup>(a)</sup>  | 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 <sup>(b)</sup>  | 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 <sup>(a)</sup> | 1,500            | *                | 3.625%          | 3.726%             |
| December 6, 2028 <sup>(b)</sup>  | 2,412            | *                | 3.125%          | 3.218%             |
| May 2, 2033 <sup>(c)</sup>       | 758              | 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 <sup>(a)</sup> | 500              | *                | 4.875%          | 4.918%             |
| <b>Total</b>                     | <b>\$ 22,782</b> | <b>\$ 15,665</b> |                 |                    |

(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 March 31, 2014 and June 30, 2013, the aggregate unamortized discount for our long-term debt, including the current portion, was \$103 million and \$65 million, respectively.

#### **Credit Facility**

We have a \$5.0 billion credit facility that expires on November 14, 2018 which serves as a back-up for our commercial paper program. As of March 31, 2014, 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 commercial paper was outstanding as of March 31, 2014 or June 30, 2013, and no amounts were drawn against the credit facility during any of the periods presented.

#### **NOTE 11 INCOME TAXES**

Our effective tax rates were approximately 19% and 20% for the three months ended March 31, 2014 and 2013, respectively, and 18% and 19% for the nine months ended March 31, 2014 and 2013, 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.

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Tax contingencies and other tax liabilities were \$9.4 billion as of March 31, 2014 and June 30, 2013 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 March 31, 2014, 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 2013.

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 2013, 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)

|                      | March 31,<br>2014 | June 30,<br>2013 |
|----------------------|-------------------|------------------|
| Commercial Licensing | \$ 15,141         | \$ 18,460        |
| Commercial Other     | 2,394             | 2,272            |
| Rest of the segments | 1,977             | 1,667            |
| <b>Total</b>         | <b>\$ 19,512</b>  | <b>\$ 22,399</b> |

**NOTE 13 COMMITMENTS AND 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 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 March 31, 2014.

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. 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 scheduled for trial in September 2015. The other two cases were inactive pending action by the Supreme Court on the British Columbia case.

**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 in late 2011 and resulted in a mistrial. In July 2012, the trial court granted Microsoft s



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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. Novell has filed a petition seeking review by the U.S. Supreme Court.

**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 with 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 in July 2012 and was affirmed on appeal in December 2013.

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 with 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. At Motorola's request, the ITC terminated its investigation of four Motorola patents. In March 2013, the ITC affirmed there was no violation of the remaining Motorola patent. Motorola 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 the 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 had committed to standards organizations 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. 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.

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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, Microsoft asserts 14 patents are infringed by Motorola Android devices and certain Motorola digital video recorders.

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**Germany**

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

Motorola asserts two patents (one now expired) are 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, orders in the litigation pending in Seattle, Washington described above enjoin Motorola from enforcing 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 that 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. One judgment has been affirmed on appeal (and Motorola has further appealed), and the other two appeals are 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 Microsoft patents. 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 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. In December 2012, the court ruled that Motorola's patent is invalid. 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. Motorola has sought to appeal that decision.

*Other patent and intellectual property claims*

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

**Other**

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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 March 31, 2014, we had accrued aggregate liabilities of \$406 million in other current liabilities and \$103 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.

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**Other Commitments**

On September 2, 2013, we announced that we entered into a definitive agreement to acquire substantially all of Nokia's Devices and 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 and 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 on April 25, 2014.

**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<br>March 31, |          | Nine Months Ended<br>March 31, |          |
|------------------------------------|---------------------------------|----------|--------------------------------|----------|
|                                    | 2014                            | 2013     | 2014                           | 2013     |
| Shares of common stock repurchased | 47                              | 36       | 147                            | 127      |
| Value of common stock repurchased  | \$ 1,791                        | \$ 1,000 | \$ 5,291                       | \$ 3,607 |

This table excludes 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 March 31, 2014, approximately \$36.2 billion remained of our \$40.0 billion share repurchase program.

**Dividends**

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

| Declaration Date        | Dividend<br>Per Share | Record Date       | Total Amount | Payment Date      |
|-------------------------|-----------------------|-------------------|--------------|-------------------|
| (in millions)           |                       |                   |              |                   |
| <b>Fiscal Year 2014</b> |                       |                   |              |                   |
| September 16, 2013      | \$ 0.28               | November 21, 2013 | \$ 2,332     | December 12, 2013 |
| November 19, 2013       | \$ 0.28               | February 20, 2014 | \$ 2,322     | March 13, 2014    |
| March 11, 2014          | \$ 0.28               | May 15, 2014      | \$ 2,313     | June 12, 2014     |

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### 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    |
| March 11, 2013     | \$ 0.23 | May 16, 2013      | \$ 1,921 | June 13, 2013     |

The estimate of the amount to be paid as a result of the March 11, 2014 declaration was included in other current liabilities as of March 31, 2014.

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**NOTE 15 ACCUMULATED OTHER COMPREHENSIVE INCOME**

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

| (In millions)  | Three Months Ended |          | Nine Months Ended |          |
|--|--------------------|----------|-------------------|----------|
|  | March 31,          |          | March 31,         |          |
|  | 2014               | 2013     | 2014              | 2013     |
| <b>Derivatives</b>   |                    |          |                   |          |
| Accumulated other comprehensive income balance, beginning of period                  | \$ 83              | \$ 38    | \$ 66             | \$ 92    |
| Unrealized gains (losses), net of tax effects of \$3, \$35, \$3, and \$31            | (2)                | 66       | 57                | 56       |
| Reclassification adjustments for gains included in revenue                           | (31)               | (47)     | (75)              | (116)    |
| Tax expense included in provision for income taxes                                   | 2                  | 16       | 4                 | 41       |
| Amounts reclassified from accumulated other comprehensive income                     | (29)               | (31)     | (71)              | (75)     |
| Net current period other comprehensive income (loss)                                 | (31)               | 35       | (14)              | (19)     |
| Accumulated other comprehensive income balance, end of period                        | \$ 52              | \$ 73    | \$ 52             | \$ 73    |
| <b>Investments</b>   |                    |          |                   |          |
| Accumulated other comprehensive income balance, beginning of period                  | \$ 3,228           | \$ 1,897 | \$ 1,794          | \$ 1,431 |
| Unrealized gains, net of tax effects of \$72, \$171, \$832, and \$432                | 133                | 317      | 1,607             | 801      |
| Reclassification adjustments for gains included in other income (expense)            | (100)              | (60)     | (163)             | (88)     |
| Tax expense included in provision for income taxes                                   | 35                 | 21       | 58                | 31       |
| Amounts reclassified from accumulated other comprehensive income                     | (65)               | (39)     | (105)             | (57)     |
| Net current period other comprehensive income  | 68                 | 278      | 1,502             | 744      |
| Accumulated other comprehensive income balance, end of period                        | \$ 3,296           | \$ 2,175 | \$ 3,296          | \$ 2,175 |
| <b>Translation adjustments and other</b>   |                    |          |                   |          |
| Accumulated other comprehensive income (loss) balance, beginning of period           | \$ (34)            | \$ 71    | \$ (117)          | \$ (101) |
| Translation adjustments and other, net of tax effects of \$9, \$(61), \$53, and \$31 | 18                 | (114)    | 101               | 58       |
| Accumulated other comprehensive loss balance, end of period                          | \$ (16)            | \$ (43)  | \$ (16)           | \$ (43)  |
| Accumulated other comprehensive income, end of period                                | \$ 3,332           | \$ 2,205 | \$ 3,332          | \$ 2,205 |

**NOTE 16 SEGMENT INFORMATION**

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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, 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.



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**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 and Office 365 Personal; 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 and Office 365 Personal ( Commercial Office 365 ), other Microsoft Office online offerings, Dynamics CRM Online, and Microsoft 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.

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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 accrues only to that segment group.

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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.

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

| (In millions)             |                                   | Three Months Ended |                  | Nine Months Ended |                  |
|---------------------------|-----------------------------------|--------------------|------------------|-------------------|------------------|
|                           |                                   | March 31,          |                  | March 31,         |                  |
|                           |                                   | 2014               | 2013             | 2014              | 2013             |
| <b>Revenue</b>            |                                   |                    |                  |                   |                  |
| Devices and Consumer      | Licensing                         | \$ 4,382           | \$ 4,352         | \$ 14,109         | \$ 14,733        |
|                           | Hardware                          | 1,973              | 1,402            | 8,187             | 5,294            |
|                           | Other                             | 1,950              | 1,656            | 5,378             | 5,055            |
|                           | <b>Total Devices and Consumer</b> | <b>\$ 8,305</b>    | <b>\$ 7,410</b>  | <b>\$ 27,674</b>  | <b>\$ 25,082</b> |
| Commercial                | Licensing                         | \$ 10,323          | \$ 9,979         | \$ 30,805         | \$ 29,059        |
|                           | Other                             | 1,902              | 1,449            | 5,285             | 4,086            |
|                           | <b>Total Commercial</b>           | <b>\$ 12,225</b>   | <b>\$ 11,428</b> | <b>\$ 36,090</b>  | <b>\$ 33,145</b> |
| Corporate and Other       |                                   | (127)              | 1,651            | (313)             | (274)            |
| <b>Total revenue</b>      |                                   | <b>\$ 20,403</b>   | <b>\$ 20,489</b> | <b>\$ 63,451</b>  | <b>\$ 57,953</b> |
| <b>Gross Margin</b>       |                                   |                    |                  |                   |                  |
| Devices and Consumer      | Licensing                         | \$ 3,906           | \$ 3,929         | \$ 12,809         | \$ 13,163        |
|                           | Hardware                          | 258                | 393              | 875               | 1,603            |
|                           | Other                             | 541                | 430              | 1,324             | 1,678            |
|                           | <b>Total Devices and Consumer</b> | <b>\$ 4,705</b>    | <b>\$ 4,752</b>  | <b>\$ 15,008</b>  | <b>\$ 16,444</b> |
| Commercial                | Licensing                         | \$ 9,430           | \$ 9,085         | \$ 28,308         | \$ 26,594        |
|                           | Other                             | 475                | 264              | 1,165             | 585              |
|                           | <b>Total Commercial</b>           | <b>\$ 9,905</b>    | <b>\$ 9,349</b>  | <b>\$ 29,473</b>  | <b>\$ 27,179</b> |
| Corporate and Other       |                                   | (148)              | 1,601            | (369)             | (317)            |
| <b>Total gross margin</b> |                                   | <b>\$ 14,462</b>   | <b>\$ 15,702</b> | <b>\$ 44,112</b>  | <b>\$ 43,306</b> |

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

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| (In millions)                   | Three Months Ended |                 | Nine Months Ended |                  |
|---------------------------------|--------------------|-----------------|-------------------|------------------|
|                                 | March 31,          |                 | March 31,         |                  |
|                                 | 2014               | 2013            | 2014              | 2013             |
| Devices and Consumer            | \$ 2,336           | \$ 2,554        | \$ 7,802          | \$ 7,843         |
| Commercial                      | 4,157              | 4,112           | 12,368            | 11,593           |
| Corporate and Other             | 995                | 1,424           | 2,665             | 3,179            |
| <b>Total operating expenses</b> | <b>\$ 7,488</b>    | <b>\$ 8,090</b> | <b>\$ 22,835</b>  | <b>\$ 22,615</b> |

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Following is operating income (loss) by segment group.

| (In millions)                 | Three Months Ended |                 | Nine Months Ended |                  |
|-------------------------------|--------------------|-----------------|-------------------|------------------|
|                               | March 31,          |                 | March 31,         |                  |
|                               | 2014               | 2013            | 2014              | 2013             |
| Devices and Consumer          | \$ 2,369           | \$ 2,198        | \$ 7,206          | \$ 8,601         |
| Commercial                    | 5,748              | 5,237           | 17,105            | 15,586           |
| Corporate and Other           | (1,143)            | 177             | (3,034)           | (3,496)          |
| <b>Total operating income</b> | <b>\$ 6,974</b>    | <b>\$ 7,612</b> | <b>\$ 21,277</b>  | <b>\$ 20,691</b> |

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 |               | Nine Months Ended |                   |
|--|--------------------|---------------|-------------------|-------------------|
|  | March 31,          |               | March 31,         |                   |
|  | 2014               | 2013          | 2014              | 2013              |
| Corporate <sup>(a)</sup>                   | \$ (968)           | \$ (1,521)    | \$ (2,635)        | \$ (3,205)        |
| Other (adjustments to U.S. GAAP):          |                    |               |                   |                   |
| Revenue reconciling amounts <sup>(b)</sup> | (127)              | 1,651         | (313)             | (274)             |
| Cost of revenue reconciling amounts        | (21)               | (50)          | (56)              | (43)              |
| Operating expenses reconciling amounts     | (27)               | 97            | (30)              | 26                |
| <b>Total Corporate and Other</b>           | <b>\$ (1,143)</b>  | <b>\$ 177</b> | <b>\$ (3,034)</b> | <b>\$ (3,496)</b> |

(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 March 31, 2014 included a net \$110 million of revenue deferrals related to sales of certain devices bundled with other products and services ( Bundled Offerings ).

Revenue reconciling amounts for the three months ended March 31, 2013 included: the recognition of \$1.1 billion of previously deferred revenue related to sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price (the Windows Upgrade Offer ); \$380

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*million of previously deferred revenue related to sales of video games with the right to receive specified software upgrades/enhancements; \$101 million of previously deferred revenue related to pre-sales of the new Office to OEMs and retailers before general availability; and a net \$92 million of previously deferred revenue 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 ).*

*Revenue reconciling amounts for the nine months ended March 31, 2014 included a net \$260 million of revenue deferrals related to Bundled Offerings.*

*Revenue reconciling amounts for the nine months ended March 31, 2013 includes: a net \$784 million of revenue deferred related to the Office Upgrade Offer, offset in part by the recognition of \$540 million of previously deferred revenue related to the Windows Upgrade Offer.*

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.

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**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 March 31, 2014, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the three-month and nine-month periods ended March 31, 2014 and 2013. 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

April 24, 2014

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

**Note About Forward-Looking Statements**

This report includes estimates, projections, statements relating to our business plans, objectives and expected operating results that 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, will likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially 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, manufacturing 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.

*Devices with end-user services*



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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 do with Xbox and Surface. 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. Xbox One was released on November 22, 2013.

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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. 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. Windows 8.1 enables new hardware and furthers the integration with other Microsoft services.

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 Microsoft 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 datacenters. The shift to the cloud is driven by three important economies of scale: larger datacenters can deploy computational resources at significantly lower cost per unit than smaller ones; larger datacenters 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, Microsoft 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 want. 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.

*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.

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

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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 the 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 deploying 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**

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 sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price (the **Windows Upgrade Offer** );

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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 original equipment manufacturers ( 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

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(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, 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 and Office 365 Personal; 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 and Office 365 Personal ( Commercial Office 365 ), other Microsoft Office online offerings, Dynamics CRM Online, and Microsoft Azure; and certain other commercial products and online services not included in the categories above.

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SUMMARY RESULTS OF OPERATIONS

Summary

| (In millions, except percentages and per share amounts) | Three Months Ended |           | Percentage | Nine Months Ended |           | Percentage |
|---|--------------------|-----------|------------|-------------------|-----------|------------|
|   | March 31,          |           | Change     | March 31,         |           | Change     |
|   | 2014               | 2013      |            | 2014              | 2013      |            |
| Revenue   | \$ <b>20,403</b>   | \$ 20,489 | (0)%       | \$ <b>63,451</b>  | \$ 57,953 | 9%         |
| Operating income  | \$ <b>6,974</b>    | \$ 7,612  | (8)%       | \$ <b>21,277</b>  | \$ 20,691 | 3%         |
| Diluted earnings per share                              | \$ <b>0.68</b>     | \$ 0.72   | (6)%       | \$ <b>2.08</b>    | \$ 1.99   | 5%         |

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*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

Revenue grew \$1.7 billion across our reportable segments, while Corporate and Other revenue declined \$1.8 billion due to the prior year recognition of deferred revenue related to the Windows Upgrade Offer, the Video Game Deferral, and the Office Deferral. Cloud Services revenue doubled, reflecting continued growth from our cloud-based offerings.

Cost of revenue increased \$1.2 billion or 24%, primarily due to higher volumes of Xbox and Surface sold, as well as \$159 million higher datacenter expenses.

Operating income decreased \$638 million or 8%, reflecting higher cost of revenue, offset in part by lower general and administrative expenses and sales and marketing expenses. Key changes in operating expenses were:

General and administrative expenses decreased \$453 million or 27%, primarily due to the EU fine in the prior year.

Sales and marketing expenses decreased \$252 million or 7%, due mainly to lower advertising costs, offset in part by increased headcount.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Revenue increased \$5.5 billion or 9%, primarily due to higher D&C Hardware, Commercial Licensing, and Commercial Other revenue. Cloud Services revenue doubled, reflecting continued growth from our cloud-based offerings.

Cost of revenue increased \$4.7 billion or 32%, primarily due to higher volumes of Xbox and Surface sold, as well as \$490 million higher datacenter expenses.

Operating income increased \$586 million or 3%, reflecting higher revenue and lower general and administrative expenses, offset in part by higher cost of revenue and research and development expenses. Key changes in operating expenses were:

Research and development expenses increased \$630 million or 8%, due mainly to increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups, and higher capitalization of new product development costs in the prior year.

General and administrative expenses decreased \$491 million or 12%, primarily due to the EU fine in the prior year.



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**SEGMENT RESULTS OF OPERATIONS****Devices and Consumer**

| (In millions, except percentages) | Three Months Ended |                 | Percentage  | Nine Months Ended |                  | Percentage  |
|-----------------------------------|--------------------|-----------------|-------------|-------------------|------------------|-------------|
|                                   | March 31,          |                 | Change      | March 31,         |                  | Change      |
|                                   | 2014               | 2013            |             | 2014              | 2013             |             |
| <b>Revenue</b>                    |                    |                 |             |                   |                  |             |
| Licensing                         | \$ 4,382           | \$ 4,352        | 1%          | \$ 14,109         | \$ 14,733        | (4)%        |
| Hardware                          | 1,973              | 1,402           | 41%         | 8,187             | 5,294            | 55%         |
| Other                             | 1,950              | 1,656           | 18%         | 5,378             | 5,055            | 6%          |
| <b>Total revenue</b>              | <b>\$ 8,305</b>    | <b>\$ 7,410</b> | <b>12%</b>  | <b>\$ 27,674</b>  | <b>\$ 25,082</b> | <b>10%</b>  |
| <b>Gross Margin</b>               |                    |                 |             |                   |                  |             |
| Licensing                         | \$ 3,906           | \$ 3,929        | (1)%        | \$ 12,809         | \$ 13,163        | (3)%        |
| Hardware                          | 258                | 393             | (34)%       | 875               | 1,603            | (45)%       |
| Other                             | 541                | 430             | 26%         | 1,324             | 1,678            | (21)%       |
| <b>Total gross margin</b>         | <b>\$ 4,705</b>    | <b>\$ 4,752</b> | <b>(1)%</b> | <b>\$ 15,008</b>  | <b>\$ 16,444</b> | <b>(9)%</b> |

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

D&C revenue increased \$895 million or 12%, reflecting sales of Xbox One and Surface, as well as higher online advertising revenue. D&C gross margin decreased slightly, reflecting changes in the mix of products and services sold.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

D&C revenue increased \$2.6 billion or 10%, reflecting sales of Xbox One and Surface, as well as higher Windows Phone revenue and online advertising revenue, offset in part by lower revenue from licenses of Consumer Windows and Consumer Office. D&C gross margin decreased \$1.4 billion or 9%, reflecting changes in the mix of products and services sold and higher online advertising cost of revenue.

**D&C Licensing**

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

D&C Licensing revenue increased slightly, due mainly to higher revenue from licenses of Consumer Office and Consumer Windows, including the impact of the expiration of support for Windows XP and higher volume in Japan. Consumer Office revenue increased 15%, due mainly to higher volumes of licenses sold, offset in part by the impact on revenue of continued softness in the consumer PC market. Windows OEM revenue increased 4%, reflecting a 19% increase in OEM Pro revenue, offset in part by continued softness in the consumer PC market.

D&C Licensing gross margin decreased slightly, due mainly to an increase in cost of revenue.

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*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

D&C Licensing revenue decreased \$624 million or 4%, due mainly to lower revenue from licenses of Consumer Windows and Consumer Office, offset in part by increased Windows Phone revenue. Retail and non-OEM sales of Windows declined \$319 million or 50%, due mainly to the launch of Windows 8 in the prior year. Windows OEM revenue declined \$226 million or 2%, reflecting continued softness in the consumer PC market, offset in part by a 12% increase in OEM Pro revenue. Consumer Office revenue declined \$368 million or 14%, reflecting the transition of customers to Office 365 Home as well as the impact on revenue of continued softness in the consumer PC market. Windows Phone revenue increased \$429 million or 33%, reflecting an increase in mobile phone patent licensing revenue and higher sales of Windows Phone licenses.

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D&C Licensing gross margin decreased \$354 million or 3%, due to decreased revenue, offset in part by a \$270 million or 17% decrease in cost of revenue. D&C Licensing cost of revenue decreased, due mainly to a \$231 million decline in traffic acquisition costs.

**D&C Hardware**

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

D&C Hardware revenue increased \$571 million or 41%, due primarily to \$398 million or 45% higher Xbox Platform revenue as well as Surface revenue growth. Surface revenue was \$494 million for the three months ended March 31, 2014. Xbox Platform revenue increased due to sales of Xbox One, which sells for a higher price than Xbox 360. We sold 2.0 million Xbox consoles during the third quarter of fiscal year 2014, compared with 1.3 million Xbox consoles during the third quarter of fiscal year 2013. Surface revenue increased due to a higher number of units sold.

D&C Hardware gross margin decreased \$135 million or 34%, due to a \$706 million or 70% increase in cost of revenue, offset in part by higher revenue. Xbox Platform cost of revenue increased \$486 million, due mainly to higher volumes of consoles sold and higher costs associated with Xbox One. Surface cost of revenue was \$539 million for the three months ended March 31, 2014, which increased due mainly to a higher number of units sold.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

D&C Hardware revenue increased \$2.9 billion or 55%, due primarily to \$1.5 billion or 38% higher Xbox Platform revenue as well as Surface revenue growth. Surface revenue was \$1.8 billion for the nine months ended March 31, 2014. Xbox Platform revenue increased due to sales of Xbox One, which sells for a higher price than Xbox 360. We sold 10.6 million Xbox consoles during the first nine months of fiscal year 2014 compared with 8.9 million Xbox consoles during the first nine months of fiscal year 2013. Surface revenue increased due to a higher number of units sold.

D&C Hardware gross margin decreased \$728 million or 45%, due to a \$3.6 billion or 98% increase in cost of revenue, offset in part by higher revenue. Xbox Platform cost of revenue increased \$2.0 billion, due mainly to higher volumes of consoles sold and higher costs associated with Xbox One. Surface cost of revenue was \$2.1 billion for the nine months ended March 31, 2014, which increased due mainly to a higher number of units sold.

**D&C Other**

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

D&C Other revenue increased \$294 million or 18%, due mainly to an increase in online advertising revenue and Subscription revenue. Online advertising revenue increased \$144 million or 16%. Search advertising revenue increased 38%, due primarily to increased revenue per search resulting from ongoing improvements in advertising products and higher search volume, offset in part by a 24% reduction in display advertising revenue. Subscription revenue was \$98 million for the three months ended March 31, 2014, reflecting subscriber growth of Office 365 Home.

D&C Other gross margin increased \$111 million or 26%, due to an increase in revenue, offset in part by a \$183 million or 15% increase in cost of revenue. D&C Other cost of revenue grew, due mainly to a \$123 million or 21% increase in online advertising cost of revenue, reflecting support of online infrastructure.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

D&C Other revenue increased \$323 million or 6%, due mainly to higher online advertising revenue and Subscription revenue, offset in part by a \$267 million decrease in first-party video games revenue, primarily due to the release of Halo 4 in the second quarter of fiscal year 2013. Online advertising revenue increased \$309 million or 12%. Search advertising revenue increased 39%, due primarily to increased revenue per search

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resulting from ongoing improvements in advertising products and higher search volume, offset in part by a 29% reduction in display advertising revenue. Subscription revenue was \$212 million for the nine months ended March 31, 2014, reflecting subscriber growth of Office 365 Home. D&C Other revenue also increased \$128 million or 11%, due to higher revenue from content resold through our online platforms.

D&C Other gross margin decreased \$354 million or 21%, due to a \$677 million or 20% increase in cost of revenue, offset in part by higher revenue. D&C Other cost of revenue grew, due mainly to a \$388 million or 23% increase in online advertising cost of revenue, reflecting support of online infrastructure and higher traffic acquisition costs. D&C Other cost of revenue also increased \$219 million or 20%, due to higher resale transactions costs.

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**Commercial**

| (In millions, except percentages) | Three Months Ended |                  | Percentage | Nine Months Ended |                  | Percentage |
|-----------------------------------|--------------------|------------------|------------|-------------------|------------------|------------|
|                                   | March 31,          |                  | Change     | March 31,         |                  | Change     |
|                                   | 2014               | 2013             |            | 2014              | 2013             |            |
| <b>Revenue</b>                    |                    |                  |            |                   |                  |            |
| Licensing                         | \$ 10,323          | \$ 9,979         | 3%         | \$ 30,805         | \$ 29,059        | 6%         |
| Other                             | 1,902              | 1,449            | 31%        | 5,285             | 4,086            | 29%        |
| <b>Total revenue</b>              | <b>\$ 12,225</b>   | <b>\$ 11,428</b> | <b>7%</b>  | <b>\$ 36,090</b>  | <b>\$ 33,145</b> | <b>9%</b>  |
| <b>Gross Margin</b>               |                    |                  |            |                   |                  |            |
| Licensing                         | \$ 9,430           | \$ 9,085         | 4%         | \$ 28,308         | \$ 26,594        | 6%         |
| Other                             | 475                | 264              | 80%        | 1,165             | 585              | 99%        |
| <b>Total gross margin</b>         | <b>\$ 9,905</b>    | <b>\$ 9,349</b>  | <b>6%</b>  | <b>\$ 29,473</b>  | <b>\$ 27,179</b> | <b>8%</b>  |

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

Commercial revenue increased \$797 million or 7%, due to growth in revenue from Cloud Services and our on-premise licensing businesses. Collectively, Commercial Office and Commercial Office 365 revenue grew 6%. Commercial gross margin increased \$556 million or 6%, in line with revenue growth.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Commercial revenue increased \$2.9 billion or 9%, due to growth in revenue from our on-premise licensing businesses and Cloud Services. Collectively, Commercial Office and Commercial Office 365 revenue grew 9%. Commercial gross margin increased \$2.3 billion or 8%, in line with revenue growth.

Commercial Licensing

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

Commercial Licensing revenue increased \$344 million or 3%, due primarily to increased revenue from our server products, including related CAL, and Commercial Windows, offset in part by the transition of customers to Cloud Services. Our server products revenue grew \$313 million or 8%, driven primarily by increased sales of Microsoft SQL Server. Commercial Windows revenue grew \$90 million or 11%.

Commercial Licensing gross margin increased \$345 million or 4%, due mainly to higher revenue.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

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Commercial Licensing revenue increased \$1.7 billion or 6%, due primarily to increased revenue from our server products and Commercial Office, each including related CAL, and Commercial Windows. Our server products revenue grew \$1.1 billion or 10%, driven primarily by increased sales of Microsoft SQL Server. Commercial Office revenue grew 4%. Commercial Office revenue was impacted by customers transitioning to Commercial Office 365. Commercial Windows revenue grew \$230 million or 9%.

Commercial Licensing gross margin increased \$1.7 billion or 6%, due mainly to higher revenue.

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**Commercial Other**

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

Commercial Other revenue increased \$453 million or 31%, due to higher Cloud Services revenue and Enterprise Services revenue. Cloud Services revenue grew \$367 million or 101%, due mainly to higher revenue from Commercial Office 365. Enterprise Services revenue grew \$85 million or 8%, due mainly to growth in Premier Support Services and Microsoft Consulting Services.

Commercial Other gross margin increased \$211 million or 80%, due to higher revenue, offset in part by a \$242 million or 20% increase in cost of revenue. The increase in cost of revenue was due mainly to higher datacenter expenses, reflecting support of online infrastructure.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Commercial Other revenue increased \$1.2 billion or 29%, due to higher Cloud Services revenue and Enterprise Services revenue. Cloud Services revenue grew \$943 million or 104%, due mainly to higher revenue from Commercial Office 365. Enterprise Services revenue grew \$254 million or 8%, due mainly to growth in Premier Support Services.

Commercial Other gross margin increased \$580 million or 99%, due to higher revenue, offset in part by a \$619 million or 18% increase in cost of revenue. The increase in cost of revenue was due mainly to higher datacenter expenses, reflecting support of online infrastructure.

**Corporate and Other**

| (In millions, except percentages) | Three Months Ended |          |            | Nine Months Ended |          |            |
|-----------------------------------|--------------------|----------|------------|-------------------|----------|------------|
|                                   | March 31,          |          | Percentage | March 31,         |          | Percentage |
|                                   | 2014               | 2013     | Change     | 2014              | 2013     | Change     |
| Revenue                           | \$ (127)           | \$ 1,651 | *          | \$ (313)          | \$ (274) | (14)%      |
| Gross margin                      | \$ (148)           | \$ 1,601 | *          | \$ (369)          | \$ (317) | (16)%      |

\* *Not meaningful*

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.

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

Corporate and Other revenue decreased \$1.8 billion, primarily due to the recognition of previously deferred revenue in the prior year. During the three months ended March 31, 2014, we deferred a net \$110 million of revenue related to Bundled Offerings. During the three months ended March 31, 2013 we recognized \$1.1 billion, \$380 million, and a net \$193 million of previously deferred revenue related to the Windows Upgrade Offer, Video Game Deferral, and the Office Deferral, respectively.

Corporate and Other gross margin decreased \$1.7 billion, in line with revenue.

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*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Corporate and Other revenue decreased slightly, primarily due to the timing of revenue deferrals. During the nine months ended March 31, 2014, we deferred a net \$260 million of revenue related to Bundled Offerings. During the nine months ended March 31, 2013, we deferred a net \$784 million of revenue related to the Office Upgrade Offer, offset in part by the recognition of \$540 million of previously deferred revenue related to the Windows Upgrade Offer.

Corporate and Other gross margin decreased slightly, in line with revenue.



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**OPERATING EXPENSES****Research and Development**

| (In millions, except percentages) | Three Months Ended<br>March 31, |          | Percentage<br>Change | Nine Months Ended<br>March 31, |          | Percentage<br>Change |
|-----------------------------------|---------------------------------|----------|----------------------|--------------------------------|----------|----------------------|
|                                   | 2014                            | 2013     |                      | 2014                           | 2013     |                      |
| Research and development          | \$ 2,743                        | \$ 2,640 | 4%                   | \$ 8,258                       | \$ 7,628 | 8%                   |
| As a percent of revenue           | 13%                             | 13%      | 0ppt                 | 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.

*Three months ended March 31, 2014 compared with three months ended March 31, 2013*

Research and development expenses increased \$103 million or 4%, due mainly to increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Research and development expenses increased \$630 million or 8%, due mainly to increased investment in new products and services in our Devices and Studios and Applications and Services engineering groups, and \$167 million higher capitalization of new product development costs in the prior year, primarily related to Office 2013 and Windows 8.

**Sales and Marketing**

| (In millions, except percentages) | Three Months Ended<br>March 31, |          | Percentage<br>Change | Nine Months Ended<br>March 31, |           | Percentage<br>Change |
|-----------------------------------|---------------------------------|----------|----------------------|--------------------------------|-----------|----------------------|
|                                   | 2014                            | 2013     |                      | 2014                           | 2013      |                      |
| Sales and marketing               | \$ 3,542                        | \$ 3,794 | (7)%                 | \$ 11,129                      | \$ 11,048 | 1%                   |
| As a percent of revenue           | 17%                             | 19%      | (2)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 March 31, 2014 compared with three months ended March 31, 2013*

Sales and marketing expenses decreased \$252 million or 7%, reflecting lower advertising costs, offset in part by increased headcount-related expenses. Advertising costs declined \$342 million or 51%, primarily due to Windows 8, Surface, and Office costs in the prior year. Average headcount grew 5% to enhance sales execution and expand our retail stores presence.

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*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Sales and marketing expenses increased slightly, primarily due to headcount-related expenses and other investment in our retail stores, offset in part by lower advertising costs. Average headcount grew 4% to enhance sales execution and expand our retail stores presence. Advertising costs declined \$248 million or 13%, primarily due to Windows 8, Surface, and Office costs in the prior year.

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**General and Administrative**

| (In millions, except percentages) | Three Months Ended<br>March 31, |          | Percentage<br>Change | Nine Months Ended<br>March 31, |          | Percentage<br>Change |
|-----------------------------------|---------------------------------|----------|----------------------|--------------------------------|----------|----------------------|
|                                   | 2014                            | 2013     |                      | 2014                           | 2013     |                      |
| General and administrative        | \$ 1,203                        | \$ 1,656 | (27)%                | \$ 3,448                       | \$ 3,939 | (12)%                |
| As a percent of revenue           | 6%                              | 8%       | (2)ppt               | 5%                             | 7%       | (2)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 March 31, 2014 compared with three months ended March 31, 2013*

General and administrative expenses decreased \$453 million or 27%, due mainly to a European Commission fine of \$561 million (approximately \$733 million) in the prior year for failure to comply with our 2009 agreement to display a Browser Choice Screen on Windows PCs where Internet Explorer is the default browser (the EU fine), offset in part by lower legal settlements and business taxes in the prior year.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

General and administrative expenses decreased \$491 million or 12%, due mainly to the EU fine in the prior year, offset in part by lower legal settlements and business taxes in the prior year as well as costs associated with preparing to close the acquisition and integrate Nokia Corporation's (Nokia) Devices and Services business.

OTHER INCOME (EXPENSE)

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

| (In millions)                                 | Three Months Ended |        | Nine Months Ended |        |
|---|--------------------|--------|-------------------|--------|
|   | March 31,          |        | March 31,         |        |
|   | 2014               | 2013   | 2014              | 2013   |
| Dividends and interest income                 | \$ 220             | \$ 150 | \$ 618            | \$ 475 |
| Interest expense                              | (175)              | (109)  | (428)             | (309)  |
| Net recognized gains on investments           | 90                 | 57     | 153               | 85     |
| Net losses on derivatives                     | (50)               | (5)    | (253)             | (66)   |
| Net losses on foreign currency remeasurements | (30)               | (22)   | (21)              | (58)   |
| Other   | (72)               | (80)   | (103)             | 89     |
| Total   | \$ (17)            | \$ (9) | \$ (34)           | \$ 216 |

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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 March 31, 2014 compared with three months ended March 31, 2013*

Dividends and interest income increased due to higher portfolio balances. Interest expense increased due to higher outstanding long-term debt. Net losses on derivatives increased due to higher losses on foreign exchange contracts, offset in part by gains on commodity derivatives. For the three months ended March 31, 2014, other includes recognized losses from certain joint ventures.

*Nine months ended March 31, 2014 compared with nine months ended March 31, 2013*

Dividends and interest income increased due to higher portfolio balances. Interest expense increased due to higher outstanding long-term debt. Net losses on derivatives increased due to higher losses on foreign exchange contracts,

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losses on equity derivatives as compared to gains in the prior period, offset in part by higher gains on commodity derivatives. For the nine months ended March 31, 2014 other reflects recognized losses from certain joint ventures, offset in part by a recognized gain on a divestiture. For the nine months ended March 31, 2013, 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 19% and 20% for the three months ended March 31, 2014 and 2013, respectively, and 18% and 19% for the nine months ended March 31, 2014 and 2013, 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.

The current quarter's effective tax rate was lower than the prior year's third quarter effective tax rate, primarily due to nonrecurring items in the prior year's third quarter effective tax rate, such as the non-deductible EU fine and transfer pricing developments related to Denmark and India which were offset by adjustments to prior year tax provision estimates and unfavorable changes in the proportion of 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 due to additional U.S. tax relief determined to be available with respect to transfer pricing developments in certain foreign tax jurisdictions, primarily Denmark.

Tax contingencies and other tax liabilities were \$9.4 billion as of March 31, 2014 and June 30, 2013, 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 March 31, 2014, 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 2013.

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 2013, 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 \$88.4 billion as of March 31, 2014, compared with \$77.0 billion as of June 30, 2013. Equity and other investments were \$14.8 billion as of March 31, 2014, 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 March 31, 2014, \$80.8 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 \$1.3 billion. As of March 31, 2014, approximately 76% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and

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agency securities, approximately 4% were invested in corporate notes and bonds of U.S. companies, and approximately 1% were invested in U.S. mortgage-backed securities, all of which are denominated in U.S. dollars.

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*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 \$794 million as of March 31, 2014. Our average and maximum securities lending payable balances for the three months ended March 31, 2014 were \$670 million and \$1.3 billion, respectively. Our average and maximum securities lending payable balances for the nine months ended March 31, 2014 were \$598 million and \$1.3 billion, 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 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 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 \$213 million or 1%, to \$22.7 billion for the nine months ended March 31, 2014, primarily due to lower revenue deferrals, partially offset by increased revenue from sales of devices. Cash used in financing decreased \$1.6 billion or 24%, to \$5.1 billion, due mainly to a \$4.7 billion increase in proceeds from issuances of debt, net of repayments, partially offset by a \$1.8 billion increase in cash used for common stock repurchases, and a \$1.0 billion increase in dividends paid. Cash used in investing decreased \$8.0 billion or 45%, to \$9.9 billion, due mainly to a \$8.1 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 \$398 million increase in cash from securities lending activities, partially offset by a \$1.7 billion increase in capital expenditures for property and equipment.

**Debt**

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.

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*Long-term debt*

As of March 31, 2014, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$22.7 billion and \$23.2 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 March 31, 2014:

| Due Date                         | Face Value       | Stated<br>Interest<br>Rate | Effective<br>Interest<br>Rate |
|----------------------------------|------------------|----------------------------|-------------------------------|
| (In millions)                    |                  |                            |                               |
| <b>Notes</b>                     |                  |                            |                               |
| 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 <sup>(a)</sup>  | 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 <sup>(b)</sup>  | 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 <sup>(a)</sup> | 1,500            | 3.625%                     | 3.726%                        |
| December 6, 2028 <sup>(b)</sup>  | 2,412            | 3.125%                     | 3.218%                        |
| May 2, 2033 <sup>(c)</sup>       | 758              | 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 <sup>(a)</sup> | 500              | 4.875%                     | 4.918%                        |
| <b>Total</b>                     | <b>\$ 22,782</b> |                            |                               |

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

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



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(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 March 31, 2014, the aggregate unamortized discount for our long-term debt, including the current portion, was \$103 million.

### *Credit facility*

We have a \$5.0 billion credit facility that expires on November 14, 2018 which serves as a back-up for our commercial paper program. As of March 31, 2014, 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 commercial paper was outstanding as of March 31, 2014 or June 30, 2013, and no amounts were drawn against the credit facility during any of the periods presented.

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**Unearned Revenue**

Unearned revenue at March 31, 2014 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 March 31, 2014 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 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.

The following table outlines the expected future recognition of unearned revenue as of March 31, 2014:

(In millions)

**Three Months Ending,**

|                    |                  |
|--------------------|------------------|
| June 30, 2014      | \$ 7,825         |
| September 30, 2014 | 4,937            |
| December 31, 2014  | 3,504            |
| March 31, 2015     | 1,404            |
| Thereafter         | 1,842            |
| <b>Total</b>       | <b>\$ 19,512</b> |

**Share Repurchases**

During the three months ended March 31, 2014, we repurchased 47 million shares of Microsoft common stock for \$1.8 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 March 31, 2014, approximately \$36.2 billion remained of our \$40.0 billion share repurchase program. All repurchases were made using cash resources.

During the nine months ended March 31, 2014, we repurchased 147 million shares of Microsoft common stock for \$5.3 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<br>Per Share | Record Date | Total Amount | Payment Date |
|------------------|-----------------------|-------------|--------------|--------------|
|------------------|-----------------------|-------------|--------------|--------------|

(in millions)

Fiscal Year 2014

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|                           |                |                          |                 |                          |
|---------------------------|----------------|--------------------------|-----------------|--------------------------|
| <b>September 16, 2013</b> | <b>\$ 0.28</b> | <b>November 21, 2013</b> | <b>\$ 2,332</b> | <b>December 12, 2013</b> |
| <b>November 19, 2013</b>  | <b>\$ 0.28</b> | <b>February 20, 2014</b> | <b>\$ 2,322</b> | <b>March 13, 2014</b>    |
| <b>March 11, 2014</b>     | <b>\$ 0.28</b> | <b>May 15, 2014</b>      | <b>\$ 2,313</b> | <b>June 12, 2014</b>     |

**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    |
| March 11, 2013     | \$ 0.23 | May 16, 2013      | \$ 1,921 | June 13, 2013     |

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**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 and 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 and 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 on April 25, 2014.

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, datacenters, 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

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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.

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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 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.

**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 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 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**

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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

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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 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.

**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



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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

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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**

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 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**

We use broad-based commodity exposures to enhance portfolio returns and facilitate portfolio diversification. Our investment portfolio has exposure to a variety of commodities, including precious metals, energy, and grain. We manage these exposures relative to global commodity indices and expect their economic risk and return to correlate with these indices.

**VALUE-AT-RISK**

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We use a value-at-risk ( VaR ) model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in the fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model is not intended to represent actual losses in fair value, including determinations of other-than-temporary losses in fair value in accordance with accounting principles generally accepted in the United States, but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

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The VaR is calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, and legal risk. The following table sets forth the one-day VaR for substantially all of our positions as of March 31, 2014 and June 30, 2013 and for the three months ended March 31, 2014:

(In millions)

| Risk Categories  | March 31,<br>2014 | June 30,<br>2013 | Three Months Ended<br>March 31,<br>2014 |        |        |
|------------------|-------------------|------------------|---|--------|--------|
|                  |                   |                  | Average                                 | High   | Low    |
| Foreign currency | \$ 199            | \$ 199           | \$ 244                                  | \$ 287 | \$ 199 |
| Interest rate    | \$ 81             | \$ 85            | \$ 80                                   | \$ 82  | \$ 78  |
| Equity           | \$ 215            | \$ 181           | \$ 217                                  | \$ 226 | \$ 208 |
| Commodity        | \$ 18             | \$ 19            | \$ 18                                   | \$ 19  | \$ 18  |

Total one-day VaR for the combined risk categories was \$391 million at March 31, 2014 and \$350 million at June 30, 2013. The total VaR is 24% less at March 31, 2014 and 28% less at June 30, 2013 than the sum of the separate risk categories in the table above due to the diversification benefit of the combination of risks.

**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

See Note 13 – Commitments and Contingencies in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding legal proceedings in which we are involved.

**ITEM 1A. RISK FACTORS**

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock.

**We face intense competition across all markets for our products and services, which may lead to lower revenue or operating margins.**

*Competition in the technology sector*

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Our competitors range in size from diversified global companies with significant research and development resources to small, specialized firms whose narrower product lines may let them be more effective in deploying technical, marketing, and financial resources. Barriers to entry in our businesses generally are low and software products can be distributed broadly and quickly at relatively low cost. Many of the areas in which we compete evolve rapidly with changing and disruptive technologies, shifting user needs, and frequent introductions of new products and services. Our ability to remain competitive depends on our success in making innovative products, devices, and services that appeal to businesses and consumers.

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**PART II**

Item 1A

*Competition among platforms, ecosystems, and devices*

An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A well-established ecosystem creates beneficial network effects among users, application developers, and the platform provider that can accelerate growth. Establishing significant scale in the marketplace is necessary to achieve and maintain attractive margins. The strategic importance of developing and maintaining a vibrant ecosystem increased with the launch of the Windows 8 operating system, Surface, Windows Phone, Xbox, and associated cloud-based services. We face significant competition from firms that provide competing platforms, applications, and services.

A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has been successful with some consumer products such as personal computers, tablets, mobile phones, gaming consoles, and digital music players. Competitors pursuing this model also earn revenue from services that are integrated with the hardware and software platform. We also offer some vertically-integrated hardware and software products and services; however, our competitors in smartphones and tablets have established significantly larger user bases. Efforts to compete with the vertically integrated model will increase our cost of revenue and reduce our operating margins.

We derive substantial revenue from licenses of Windows operating systems on personal computers. We face substantial competitive challenges from competing platforms developed for new devices and form factors such as smartphones and tablet computers. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users are increasingly turning to these devices to perform functions that in the past would have been performed by personal computers. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract applications developers to our platforms. In addition, Surface competes with products made by our OEM partners, which may affect their commitment to our platform.

Competing platforms have applications marketplaces (sometimes referred to as "stores") with scale and significant installed bases on mobile devices. These applications leverage free and user-paid services that over time result in disincentives for users to switch to competing platforms. In order to compete, we must successfully enlist developers to write applications for our marketplace and ensure that these applications have high quality, customer appeal, and value. Efforts to compete with these application marketplaces may increase our cost of revenue and lower our operating margins.

*Business model competition*

Companies compete with us based on a growing variety of business models.

Under the license-based proprietary software model that generates most of our revenue, we bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from licensing our products. Many of our competitors also develop and sell software to businesses and consumers under this model and we expect this competition to continue.

Other competitors develop and offer free applications, online services and content, and make money by selling third-party advertising. Advertising revenue funds development of products and services these competitors provide to users at no or little cost, competing directly with our revenue-generating products.

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Some companies compete with us using an open source business model by modifying and then distributing open source software at nominal cost to end-users and earning revenue on advertising or complementary services and products. These firms do not bear the full costs of research and development for the software. Some open source software vendors develop software that mimics the features and functionality of our products.

The competitive pressures described above may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives. This may lead to lower revenue, gross margins, and operating income.

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**PART II**

Item 1A

**Our increasing focus on services presents execution and competitive risks.** A growing part of our strategy involves cloud-based services used with smart devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud and in some cases the user choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our own competing cloud-based strategies. The Windows ecosystem must continue to evolve with this changing environment. While we believe our expertise, investments in infrastructure, and the breadth of our cloud-based services provide us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

continuing to bring to market compelling cloud-based experiences that generate increasing traffic and market share;

maintaining the utility, compatibility, and performance of our cloud-based services on the growing array of computing devices, including PCs, smartphones, tablets, and television-related devices including gaming consoles;

continuing to enhance the attractiveness of our cloud platforms to third-party developers; and

ensuring that our cloud-based services meet the reliability expectations of our customers and maintain the security of their data.

In July 2013, we announced a change in organizational structure as part of our transformation to a devices and services company. This change in structure is designed to enable us to innovate with greater speed, efficiency, and capability in the fast-changing competitive environment. We expect this change to alter the way we plan, develop, and market our products and services, as we pursue a single strategy to offer a family of devices and services designed to empower our customers for the activities they value most. It is uncertain whether our One Microsoft strategy will yield the anticipated efficiencies or competitive benefits.

As we increasingly license cloud-based versions of our products and services, such as Office 365, 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 period of the subscription.

**We make significant investments in new products and services that may not be profitable.** We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, the Windows Store, the Microsoft Azure Services platform, Office 365, other cloud-based services offerings, and the Xbox entertainment platform. We will continue to invest in new software and hardware products, services, and technologies, such as the Microsoft-designed and manufactured Surface devices. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product, service, and distribution channel investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for some new products and businesses will not be as high as the margins we have experienced historically.

In 2012, we launched Windows 8, a major new release of our operating system, which seeks to deliver a unique user experience through well-integrated software, hardware, and services. In 2013, we released the Windows 8.1 update. The success of Windows 8 depends on a number of factors including the extent to which customers embrace the new user interface and functionality, successfully coordinating with our OEM partners in releasing a variety of hardware devices that take advantage of new features, pricing Windows 8-based devices competitively, and attracting developers at scale to ensure a competitive array of quality applications. The marketing costs we are incurring to promote



Windows 8 and associated services and devices may reduce our operating margins.

**Acquisitions, joint ventures, and strategic alliances may have an adverse effect on our business.** We expect to continue making acquisitions or entering into joint ventures and strategic alliances as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we do not get a satisfactory return on our investment, that we have difficulty integrating new employees, business systems, and technology, or that the transaction distracts management from

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our other businesses. In September 2013, we announced an agreement with Nokia Corporation to acquire substantially all its Devices and Services business, including patent licensing and financing agreements. Factors that may prevent us from realizing the financial and other benefits from this transaction include: the response to the acquisition by the customers, employees, and strategic and business partners of Nokia's Devices and Services business; the extent to which we achieve anticipated operating efficiencies and cost savings, and anticipated smart device and mobile phone market share targets; the overall growth rates for the smart device and mobile phone markets; ongoing downward pressure on prices for mobile devices; unanticipated restructuring expenses; any restrictions or limitations imposed by regulatory authorities; our management and organizational changes resulting from acquisition of Nokia's Devices and Services business; the ability to retain key Nokia personnel; our effectiveness in integrating the Nokia Devices and Services business with Microsoft's businesses; the response of existing Microsoft smart devices original equipment manufacturers; and risks related to the Nokia Devices and Services international operations. These transactions provide opportunities to enhance our existing products and services; their success will depend in part on our ability to provide compelling experiences that distinguish us from our competitors in consumer and business markets. It may take longer than expected to realize the full benefits from these transactions, such as increased revenue, enhanced efficiencies, or increased market share, or the benefits may ultimately be smaller than we expected. These events could adversely affect our operating results or financial condition.

**We may not be able to adequately protect our intellectual property rights.** Protecting our global intellectual property rights and combating unlicensed copying and use of our software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. As a result, our revenue in these markets may grow slower than the underlying PC market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

**Third parties may claim we infringe their intellectual property rights.** From time to time, others claim we infringe their intellectual property rights. The number of these claims may grow because of constant technological change in the markets in which we compete, the extensive patent coverage of existing technologies, the rapid rate of issuance of new patents, and our offering of Microsoft-branded services and hardware devices, such as Surface. To resolve these claims we may enter into royalty and licensing agreements on terms that are less favorable than currently available, stop selling or redesign affected products or services, or pay damages to satisfy indemnification commitments with our customers. These outcomes may cause operating margins to decline. In addition to money damages, in some jurisdictions plaintiffs can seek injunctive relief that may limit or prevent importing, marketing, and selling our products or services that have infringing technologies. In some countries, such as Germany, an injunction can be issued before the parties have fully litigated the validity of the underlying patents. We have paid significant amounts to settle claims related to the use of technology and intellectual property rights and to procure intellectual property rights as part of our strategy to manage this risk, and may continue to do so in the future.

**We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code.** Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If a significant portion of our source code leaks, we could potentially lose future trade secret protection for that source code. It may become easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code also could increase the security risks described in the next paragraph.

**Cyber-attacks and security vulnerabilities could lead to reduced revenue, increased costs, liability claims, or harm to our competitive position.**

*Security of Microsoft's information technology*

Threats to information technology (IT) security can take a variety of forms. Individual and groups of hackers, as well as sophisticated organizations including state-sponsored organizations, may take steps that pose threats to our customers and our IT. They may develop and deploy malicious software to attack our products and services and gain access to our networks and datacenters, or act in a coordinated manner to launch distributed denial of service or



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other coordinated attacks. Breaches of our network or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, result in product development delays, compromise confidential or technical business information harming our competitive position, result in theft or misuse of our intellectual property, or otherwise adversely affect our business.

In addition, our internal IT environment continues to evolve. Often we are early adopters of new devices and technologies. We embrace new ways of sharing data and communicating internally and with partners and customers using methods such as social networking and other consumer-oriented technologies. These practices can enhance efficiency and business insight, but they also present risks that our business policies and internal security controls may not keep pace with the speed of these changes.

*Security of our customers' products and services*

Security threats are a particular challenge to companies like us whose business is technology products and services. Threats to our own IT infrastructure also affect our customers. Customers using our cloud-based services rely on the security of our infrastructure to ensure the reliability of our services and the protection of their data. Hackers tend to focus their efforts on the most popular operating systems, programs, and services, including many of ours, and we expect that to continue. The security of our products and services is important in our customers purchasing decisions.

We devote significant resources to defend against security threats, both to our internal IT systems and those of our customers. These include:

engineering more secure products and services;

enhancing security and reliability features in our products and services, and continuously evaluating and updating those security and reliability features;

improving the deployment of software updates to address security vulnerabilities;

investing in mitigation technologies that help to secure customers from attacks even when software updates are not deployed;

protecting the digital security infrastructure that ensures the integrity of our products and services;

helping our customers make the best use of our products and services to protect against computer viruses and other attacks; and

providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products and services could harm our reputation and lead some customers to reduce or delay future purchases of products or subscriptions to services, or to use competing products or services. Customers may also spend more on protecting their existing computer systems from attack, which could delay adoption of additional products or services. Any of these actions by customers could adversely affect our revenue. Actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure

to liability, there is no assurance these provisions will withstand legal challenges. Legislative or regulatory action in these areas may increase the costs to develop or implement our products and services.

**Disclosure of personal data could result in liability and harm our reputation.** As we continue to grow the number and scale of our cloud-based offerings, we store and process increasingly large amounts of personally identifiable information of our customers. At the same time, the continued occurrence of high-profile data breaches provides evidence of an external environment increasingly hostile to information security. Despite our efforts to improve the security controls across our business groups and geographies, it is possible our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information that we or our vendors store and manage. Improper disclosure could harm our reputation, lead to legal exposure to customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data on premise or, increasingly, in a cloud-based environment we host. We believe consumers using our email, messaging, storage, sharing, and social networking services will increasingly want efficient, centralized methods of choosing their privacy preferences and controlling their data. Like all providers of communications services, government authorities can sometimes require us to

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produce customer data in response to valid legal orders. In the U.S. and elsewhere, we advocate for transparency concerning these requests and appropriate limitations on government authority to compel disclosure. Despite our efforts to protect customer data, perceptions that the privacy of personal information is not satisfactorily protected could inhibit sales of our products or services, and could limit adoption of our cloud-based solutions by consumers, businesses, and government entities. Additional security measures we may take to address customer concerns, or constraints on our flexibility to determine where and how to operate datacenters, may result in higher operating expenses.

**We may have outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure.** Our increasing user traffic and the complexity of our products and services demand more computing power. We spend substantial amounts to purchase or lease datacenters and equipment and to upgrade our technology and network infrastructure to handle more traffic on our websites and in our datacenters, and to introduce new products and services and support existing services such as Bing, Exchange Online, Office 365, SharePoint Online, OneDrive, Skype, Xbox Live, Microsoft Azure, Outlook.com, and Microsoft Office Web Apps. We also are growing our business of providing a platform and back-end hosting for services provided by third-parties to their end users. Maintaining and expanding this infrastructure is expensive and complex. Inefficiencies or operational failures, including temporary or permanent loss of customer data, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

**Government litigation and regulatory activity may limit how we design and market our products.** As a leading global software maker, we are closely scrutinized by government agencies under U.S. and foreign competition laws. Some jurisdictions also allow competitors or consumers to assert claims of anti-competitive conduct. For example, we were sued on competition law grounds by the U.S. Department of Justice, 18 states, and the District of Columbia in the late 1990s. The resolution of the government lawsuits imposed various constraints on our Windows operating system businesses. Although these constraints expired in May 2011, we expect that federal and state antitrust authorities will continue to closely scrutinize our business.

The European Commission closely scrutinizes the design of high-volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. In 2004, the Commission ordered us to create new versions of Windows that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. In 2009, the Commission accepted a set of commitments offered by Microsoft to address the Commission's concerns relating to competition in Web browsing software, including an undertaking to address Commission concerns relating to interoperability. These obligations may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our products, which could hamper sales of our products.

Government regulatory actions and court decisions such as these may hinder our ability to provide the benefits of our software to consumers and businesses, reducing the attractiveness of our products and the revenue that come from them. New competition law actions could be initiated at any time. The outcome of such actions, or steps taken to avoid them, could adversely affect us in a variety of ways, including:

We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail a delay in a product release and removing functionality that customers want or on which developers rely.

We may be required to make available licenses to our proprietary technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.

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The rulings described above may be used as precedent in other competition law proceedings.

We are subject to a variety of ongoing commitments as a result of court or administrative orders, consent decrees or other voluntary actions we have taken. If we fail to comply with these commitments we may incur litigation costs and be subject to substantial fines or other remedial actions. For example, in July 2012, we announced that, for some PCs sold in Europe, we were not in compliance with our 2009 agreement to display a Browser Choice Screen on Windows PCs where Internet Explorer is the default browser. As a result, the European Commission imposed a fine of 561 million (approximately \$733 million).

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Our products and online services offerings, including new technologies we develop or acquire such as Skype, are subject to government regulation in some jurisdictions, including in areas of user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear, subject to change over time, and sometimes may conflict from jurisdiction to jurisdiction. Additionally these laws and governments' approach to their enforcement, as well as our products and services, are continuing to evolve. Compliance with these types of regulation may involve significant costs or require changes in products or business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop the alleged noncompliant activity.

**Our business depends on our ability to attract and retain talented employees.** Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

**Delays in product development schedules may adversely affect our revenue.** The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Our increasing focus on devices and cloud-based services also presents new and complex development issues. Significant delays in new product or service releases or significant problems in creating new products or services could adversely affect our revenue.

**Adverse economic or market conditions may harm our business.** Worsening economic conditions, including inflation, recession, or other changes in economic conditions, may result in lower IT spending and adversely affect our revenue. If demand for PCs, servers, and other computing devices declines, or consumer or business spending for those products declines, our revenue will be adversely affected. A substantial amount of our revenue comes from U.S. government contracts. An extended federal government shutdown resulting from the failure to pass budget appropriations, adopt continuing funding resolutions or raise the debt ceiling, as well as other budgetary decisions limiting or delaying federal government spending generally, could reduce government IT spending on our products and services and adversely affect our revenues. Our product distribution system also relies on an extensive partner and retail network. OEMs building devices that run our software have also been a significant means of distribution. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, OEM, or retailer, could result in sales channel disruption. Challenging economic conditions also may impair the ability of our customers to pay for products and services they have purchased. As a result, allowances for doubtful accounts and write-offs of accounts receivable may increase. We maintain an investment portfolio of various holdings, types, and maturities. These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that affect global financial markets. A significant part of our investment portfolio consists of U.S. government securities. If global credit and equity markets decline for long periods, or if there is a downgrade of the U.S. government credit rating due to an actual or threatened default on government debt, our investment portfolio may be adversely impacted and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely affect our financial results.

**We have claims and lawsuits against us that may result in adverse outcomes.** We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. The litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. A material adverse impact on our financial statements also could occur for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

**We may have additional tax liabilities.** We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Economic and political pressures to increase tax revenues in various jurisdictions may make resolving tax disputes more difficult. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made.





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We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions to the U.S. may result in higher effective tax rates for the company. In addition, there have been proposals from Congress to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form any proposed legislation may pass, if enacted it could have a material adverse impact on our tax expense and cash flows.

**Our hardware and software products may experience quality or supply problems.** Our vertically-integrated hardware products such as the Xbox console, Surface, and other hardware devices we design and market are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We get some device components from sole suppliers. Our competitors use some of the same suppliers and their demand for hardware components can affect the capacity available to us. If a component from a sole-source supplier is delayed or becomes unavailable, whether because of supplier capacity constraint or industry shortages, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Component shortages, excess or obsolete inventory, or price reductions resulting in inventory adjustments may increase our cost of revenue. Xbox consoles and Surface are assembled in Asia; disruptions in the supply chain may result in shortages that would affect our revenue and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

Our stand-alone software products also may experience quality or reliability problems. The highly sophisticated software products we develop may contain bugs and other defects that interfere with their intended operation. Any defects we do not detect and fix in pre-release testing could result in reduced sales and revenue, damage to our reputation, repair or remediation costs, delays in the release of new products or versions, or legal liability. Although our license agreements typically contain provisions that eliminate or limit our exposure to liability, there is no assurance these provisions will withstand legal challenge.

**If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings.** We acquire other companies and intangible assets and may not realize all the economic benefit from those acquisitions, which could result in an impairment of goodwill or intangibles. Under accounting principles generally accepted in the United States, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in our stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations. For example, in the fourth quarter of fiscal year 2012, we recorded a \$6.2 billion charge for the impairment of goodwill in our previous Online Services Division business (Devices and Consumer Other under our current segment structure).

**We operate a global business that exposes us to additional risks.** We operate in over 100 countries and a significant part of our revenue comes from international sales. Competitive or regulatory pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the U.S. and other countries. Operations outside the U.S. may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment. The Foreign Corrupt Practices Act and local laws ( Anti-Corruption Laws ) prohibit corrupt payments by our employees, vendors, or agents. While we devote substantial resources to our global compliance programs and have implemented policies, training, and internal controls designed to reduce the risk of corrupt payments, if we fail to comply with Anti-Corruption Laws, we may be exposed to significant fines and penalties. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks, including deterioration of social, political, labor, or economic conditions in a specific country or region, and difficulties in staffing and managing foreign operations. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our revenue.

**Catastrophic events or geo-political conditions may disrupt our business.** A disruption or failure of our systems or operations because of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or IT systems could harm our ability to conduct normal



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business operations. Our move toward providing our customers with more services and solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged service outages on our operating results.

Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may result in supply chain disruptions for hardware manufacturers, either of which may adversely affect our revenue. The long-term effects of climate change on the global economy in general or the IT industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Items 2(a) and (b) are not applicable.

**(c) STOCK REPURCHASES**

| Period                               | Total Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans<br>or Programs | Approximate Dollar Value of   |
|--------------------------------------|--|------------------------------------|--|---|
|                                      |  |                                    |  | Shares<br>that May Yet be<br>Purchased under the Plans<br>or Programs |
|                                      |  |                                    |  | (in millions)   |
| January 1, 2014 – January 31, 2014   | 0                                      | n/a                                | 0  | \$ 38,000   |
| February 1, 2014 – February 28, 2014 | 29,994,262                             | \$ 37.35                           | 29,994,262   | \$ 36,880   |
| March 1, 2014 – March 31, 2014       | 17,467,660                             | \$ 38.43                           | 17,467,660   | \$ 36,209   |
|                                      | <u>47,461,922</u>                      |                                    | <u>47,461,922</u>  |   |

During the three months ended March 31, 2014, we repurchased 47 million shares of Microsoft common stock for \$1.8 billion under a \$40.0 billion share repurchase program approved by our Board of Directors on September 16, 2013. All repurchases were made using cash resources. Our stock repurchases may occur through open market purchases or pursuant to a Rule 10b5-1 trading plan. 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 March 31, 2014, approximately \$36.2 billion remained of our \$40.0 billion share repurchase program.

Excluded from this disclosure are shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards.

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Item 6

**ITEM 6. EXHIBITS**

|         |   |
|---------|---|
| 10.23*  | Offer Letter, dated February 3, 2014, between Microsoft Corporation and Satya Nadella (incorporated by reference to Current Report on Form 8-K filed on February 4, 2014) |
| 15      | Letter regarding unaudited interim financial information  |
| 31.1    | Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2    | Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1**  | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2**  | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101.INS | XBRL Instance Document  |
| 101.SCH | XBRL Taxonomy Extension Schema  |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase  |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase   |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase  |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase   |

\* *Indicates a management contract or compensatory plan or arrangement*

\*\* *Furnished, not filed.*

**Items 3, 4, and 5 are not applicable and have been omitted.**

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MICROSOFT CORPORATION

/s/ FRANK H. BROD

Frank H. Brod

Corporate Vice President, Finance and Administration;

Chief Accounting Officer (Duly Authorized Officer)

April 24, 2014