MICROSOFT CORP
Form 10-Q
October 26, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2017

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: 001-37845

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

Washington	91-1144442
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Microsoft Way, Redmond, Washington	98052-6399

(Address of principal executive offices) (Zip Code)

(425) 882-8080

(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 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 No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Class	Outstanding as of October 20, 2017
Common Stock, $0.00000625 par value per share	7,714,590,195 shares

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended September 30, 2017

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)

Three Months Ended September 30,	2017	2016
Revenue:		
Product	$ 14,298	$ 14,968
Service and other	10,240	6,960
Total revenue	24,538	21,928
Cost of revenue:		
Product	2,980	3,581
Service and other	5,298	4,263
Total cost of revenue	8,278	7,844
Gross margin	16,260	14,084
Research and development	3,574	3,106
Sales and marketing	3,812	3,218
General and administrative	1,166	1,045
Operating income	7,708	6,715
Other income, net	276	112
Income before income taxes	7,984	6,827
Provision for income taxes	1,408	1,160
Net income	$6,576	$5,667
Earnings per share:		

Basic	$0.85	$0.73
Diluted	$0.84	$0.72
Weighted average shares outstanding:		
Basic	7,708	7,789
Diluted	7,799	7,876
Cash dividends declared per common share	$0.42	$0.39

Refer to accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	2017	2016
Net income	$ 6,576	$ 5,667
Other comprehensive income (loss), net of tax:		
Net change related to derivatives	(106)	(37)
Net change related to investments	(288)	83
Translation adjustments and other	293	118
Other comprehensive income (loss)	(101)	164
Comprehensive income	$6,475	$ 5,831

Refer to accompanying notes. Refer to Note 18 – Accumulated Other Comprehensive Income for further information.

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BALANCE SHEETS

(In millions) (Unaudited)

	September 30, 2017	June 30, 2017
Assets		
Current assets:		
Cash and cash equivalents	$6,884	$7,663
Short-term investments (including securities loaned of $4,774 and $3,694)	131,587	125,318
Total cash, cash equivalents, and short-term investments	138,471	132,981
Accounts receivable, net of allowance for doubtful accounts of $285 and $345	14,561	22,431
Inventories	3,211	2,181
Other	4,788	5,103
Total current assets	161,031	162,696
Property and equipment, net of accumulated depreciation of $25,523 and $24,179	24,809	23,734
Operating lease right-of-use assets	6,844	6,555
Equity and other investments	5,343	6,023
Goodwill	35,389	35,122
Intangible assets, net	9,598	10,106
Other long-term assets	6,083	6,076
Total assets	$ 249,097	$250,312
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$6,866	$7,390
Short-term debt	8,170	9,072
Current portion of long-term debt	1,050	1,049
Accrued compensation	4,108	5,819
Income taxes	920	718
Short-term unearned revenue	22,778	24,013
Securities lending payable	203	97
Other	7,520	7,587
Total current liabilities	51,615	55,745

Long-term debt	76,255	76,073
Long-term unearned revenue	2,126	2,643
Deferred income taxes	5,513	5,734
Operating lease liabilities	5,768	5,372
Other long-term liabilities	18,173	17,034
Total liabilities	159,450	162,601
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 7,720 and 7,708	69,419	69,315
Retained earnings	19,702	17,769
Accumulated other comprehensive income	526	627
Total stockholders' equity	89,647	87,711
Total liabilities and stockholders' equity	$ 249,097	$ 250,312

Refer to accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	2017	2016
Operations		
Net income	$6,576	$5,667
Adjustments to reconcile net income to net cash from operations:		
Depreciation, amortization, and other	2,499	1,816
Stock-based compensation expense	973	703
Net recognized gains on investments and derivatives	(523)	(311)
Deferred income taxes	(53)	540
Changes in operating assets and liabilities:		
Accounts receivable	7,949	7,187
Inventories	(1,023)	(867)
Other current assets	(318)	(965)
Other long-term assets	(278)	(93)
Accounts payable	(407)	(443)
Unearned revenue	(1,806)	(1,807)
Other current liabilities	(1,962)	(321)
Other long-term liabilities	813	443
Net cash from operations	12,440	11,549
Financing		
Repayments of short-term debt, maturities of 90 days or less, net	(3,710)	(3,390)
Proceeds from issuance of debt	3,954	24,977
Repayments of debt	(1,169)	(225)
Common stock issued	307	241
Common stock repurchased	(2,570)	(4,362)
Common stock cash dividends paid	(3,003)	(2,800)
Other, net	(150)	(112)
Net cash from (used in) financing	(6,341)	14,329
Investing		
Additions to property and equipment	(2,132)	(2,163)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(179)	(24)
Purchases of investments	(32,961)	(57,181)

Maturities of investments	5,226	8,659
Sales of investments	23,036	32,323
Securities lending payable	106	(84)
Net cash used in investing	(6,904)	(18,470)
Effect of foreign exchange rates on cash and cash equivalents	26	10
Net change in cash and cash equivalents	(779)	7,418
Cash and cash equivalents, beginning of period	7,663	6,510
Cash and cash equivalents, end of period	$6,884	$13,928

Refer to accompanying notes.

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STOCKHOLDERS’ EQUITY STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	2017	2016
Common stock and paid-in capital		
Balance, beginning of period	$69,315	$68,178
Common stock issued	307	241
Common stock repurchased	(1,175)	(1,374)
Stock-based compensation expense	973	703
Other, net	(1)	(1)
Balance, end of period	69,419	67,747
Retained earnings		
Balance, beginning of period	17,769	13,118
Net income	6,576	5,667
Common stock cash dividends	(3,239)	(3,025)
Common stock repurchased	(1,404)	(3,003)
Balance, end of period	19,702	12,757
Accumulated other comprehensive income		
Balance, beginning of period	627	1,794
Other comprehensive income (loss)	(101)	164
Balance, end of period	526	1,958
Total stockholders’ equity	$ 89,647	$ 82,462

Refer to accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 — ACCOUNTING POLICIES

Accounting Principles

Our unaudited interim consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair presentation of the results for the interim periods presented. 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 2017 Form 10-K filed with the U.S. Securities and Exchange Commission on August 2, 2017.

Principles of Consolidation

The consolidated financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments for 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 for 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: for revenue recognition, determining the nature and timing of satisfaction of performance obligations, and determining the standalone selling price ("SSP") of performance obligations, variable consideration, and other obligations such as product returns and refunds; loss contingencies; product warranties; the fair value of and/or potential impairment of goodwill and intangible assets for our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; the market value of, and demand for, our inventory; and stock-based compensation forfeiture rates. Examples of assumptions include: when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized on our consolidated 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.

Revenue

Product Revenue and Service and Other Revenue

Product revenue includes sales from operating systems; cross-device productivity applications; server applications; business solution applications; desktop and server management tools; software development tools; video games; and hardware such as PCs, tablets, gaming and entertainment consoles, other intelligent devices, and related accessories.

Service and other revenue includes sales from cloud-based solutions that provide customers with software, services, platforms, and content such as Microsoft Office 365, Microsoft Azure, Microsoft Dynamics 365, and Xbox Live; solution support; and consulting services. Service and other revenue also includes sales from online advertising and LinkedIn.

Revenue Recognition

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration we expect to receive in exchange for those products or services. We enter into contracts that can include various combinations of products and services, which are generally capable of being distinct and accounted for as separate performance obligations. Revenue is recognized net of allowances for returns and any taxes collected from customers, which are subsequently remitted to governmental authorities.

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Nature of Products and Services

Licenses for on-premises software provide the customer with a right to use the software as it exists when made available to the customer. Customers may purchase perpetual licenses or subscribe to licenses, which provide customers with the same functionality and differ mainly in the duration over which the customer benefits from the software. Revenue from distinct on-premises licenses is recognized upfront at the point in time when the software is made available to the customer. In cases where we allocate revenue to software updates, primarily because the updates are provided at no additional charge, revenue is recognized as the updates are provided, which is generally ratably over the estimated life of the related device or license.

Certain volume licensing programs, including Enterprise Agreements, include on-premises licenses combined with Software Assurance ("SA"). SA conveys rights to new software and upgrades released over the contract period and provides support, tools, and training to help customers deploy and use products more efficiently. On-premises licenses are considered distinct performance obligations when sold with SA. Revenue allocated to SA is generally recognized ratably over the contract period as customers simultaneously consume and receive benefits, given that SA comprises distinct performance obligations that are satisfied over time.

Cloud services, which allow customers to use hosted software over the contract period without taking possession of the software, are provided on either a subscription or consumption basis. Revenue related to cloud services provided on a subscription basis is recognized ratably over the contract period. Revenue related to cloud services provided on a consumption basis, such as the amount of storage used in a period, is recognized based on the customer utilization of such resources. When cloud services require a significant level of integration and interdependency with software and the individual components are not considered distinct, all revenue is recognized over the period in which the cloud services are provided.

Revenue from search advertising is recognized when the advertisement appears in the search results or when the action necessary to earn the revenue has been completed. Revenue from consulting services is recognized as services are provided.

Our hardware is generally highly dependent on, and interrelated with, the underlying operating system and cannot function without the operating system. In these cases, the hardware and software license are accounted for as a single performance obligation and revenue is recognized at the point in time when ownership is transferred to resellers or directly to end customers through retail stores and online marketplaces.

Refer to Note 19 – Segment Information and Geographic Data for further information, including revenue by significant product and service offering.

Significant Judgments

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. Certain cloud services, such as Office 365, depend on a significant level of integration and interdependency between the desktop applications and cloud services. Judgment is required to determine whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time.

Judgment is required to determine the SSP for each distinct performance obligation. We use a single amount to estimate SSP for items that are not sold separately, including on-premises licenses sold with SA or software updates provided at no additional charge. We use a range of amounts to estimate SSP when we sell each of the products and services separately and need to determine whether there is a discount that needs to be allocated based on the relative SSP of the various products and services.

In instances where SSP is not directly observable, such as when we do not sell the product or service separately, we determine the SSP using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual products and services due to the stratification of those products and services by customers and circumstances. In these instances, we may use information such as the size of the customer and geographic region in determining the SSP.

Due to the various benefits from and the nature of our SA program, judgment is required to assess the pattern of delivery, including the exercise pattern of certain benefits across our portfolio of customers.

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Our products are generally sold with a right of return and we may provide other credits or incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize. Returns and credits are estimated at contract inception and updated at the end of each reporting period as additional information becomes available and only to the extent that it is probable that a significant reversal of any incremental revenue will not occur.

Contract Balances

Timing of revenue recognition may differ from the timing of invoicing to customers. We record a receivable when revenue is recognized prior to invoicing, or unearned revenue when revenue is recognized subsequent to invoicing. For multi-year agreements, we generally invoice customers annually at the beginning of each annual coverage period. We record a receivable related to revenue recognized for multi-year on-premises licenses as we have an unconditional right to invoice and receive payment in the future related to those licenses.

The opening balance of current and long-term accounts receivable, net of allowance for doubtful accounts, was $22.3 billion as of July 1, 2016.

As of September 30, 2017 and June 30, 2017, long-term accounts receivable, net of allowance for doubtful accounts, were $1.6 billion and $1.7 billion, respectively, and are included in other long-term assets on our consolidated balance sheets.

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence.

Activity in the allowance for doubtful accounts was as follows:

(In millions)	
Three Months Ended September 30, 2017	
Balance, beginning of period	$361
Charged to costs and other	(45)
Write-offs	(16)
Balance, end of period	$300
Reported as of September 30, 2017	
Accounts receivable, net of allowance for doubtful accounts	$285
Other long-term assets	15

Total	$300

Unearned revenue is comprised mainly of unearned revenue related to volume licensing programs, which may include SA and cloud services. Unearned revenue is generally invoiced annually at the beginning of each contract period for multi-year agreements and recognized ratably over the coverage period. Unearned revenue also includes payments for: consulting services to be performed in the future; Office 365 subscriptions; LinkedIn subscriptions; Xbox Live subscriptions; Windows 10 post-delivery support; Dynamics business solutions; Skype prepaid credits and subscriptions; and other offerings for which we have been paid in advance and earn the revenue when we transfer control of the product or service.

Refer to Note 14 – Unearned Revenue for further information, including unearned revenue by segment and changes in unearned revenue during the period.

Payment terms and conditions vary by contract type, although terms generally include a requirement of payment within 30 to 60 days. In instances where the timing of revenue recognition differs from the timing of invoicing, we have determined our contracts generally do not include a significant financing component. The primary purpose of our invoicing terms is to provide customers with simplified and predictable ways of purchasing our products and services, not to receive financing from our customers, such as invoicing at the beginning of a subscription term with revenue recognized ratably over the contract period, or to provide customers with financing, such as multi-year on-premises licenses that are invoiced annually with revenue recognized upfront.

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Assets Recognized from the Costs to Obtain a Contract with a Customer

We recognize an asset for the incremental costs of obtaining a contract with a customer if we expect the benefit of those costs to be longer than one year. We have determined that certain sales incentive programs meet the requirements to be capitalized. Total capitalized costs to obtain a contract were immaterial during the periods presented and are included in other current and long-term assets on our consolidated balance sheets.

We apply a practical expedient to expense costs as incurred for costs to obtain a contract when the amortization period would have been one year or less. These costs include our internal sales force compensation program and certain partner sales incentive programs as we have determined annual compensation is commensurate with annual sales activities.

Leases

We determine if an arrangement is a lease at inception. Operating leases are included in operating lease right-of-use (“ROU”) assets, other current liabilities, and operating lease liabilities on our consolidated balance sheets. Finance leases are included in property and equipment, other current liabilities, and other long-term liabilities on our consolidated balance sheets.

Operating lease ROU assets and operating lease liabilities are recognized based on the present value of the future minimum lease payments over the lease term at commencement date. As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at commencement date in determining the present value of future payments. The operating lease ROU asset also includes any lease payments made and excludes lease incentives and initial direct costs incurred. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense for minimum lease payments is recognized on a straight-line basis over the lease term.

We have lease agreements with lease and non-lease components, which are generally accounted for separately. For certain equipment leases, such as vehicles, we account for the lease and non-lease components as a single lease component. Additionally, for certain equipment leases, we apply a portfolio approach to effectively account for the operating lease ROU assets and liabilities.

Recent Accounting Guidance

Recently Adopted Accounting Guidance

Leases

In February 2016, the Financial Accounting Standards Board (“FASB”) issued a new standard related to leases to increase transparency and comparability among organizations by requiring the recognition of ROU assets and lease liabilities on the balance sheet. Most prominent among the changes in the standard is the recognition of ROU assets and lease liabilities by lessees for those leases classified as operating leases. Under the standard, disclosures are required to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We are also required to recognize and measure leases existing at, or entered into after, the beginning of the earliest comparative period presented using a modified retrospective approach, with certain practical expedients available.

We elected to early adopt the standard effective July 1, 2017 concurrent with our adoption of the new standard related to revenue recognition. We elected the available practical expedients and implemented internal controls and key system functionality to enable the preparation of financial information on adoption.

The standard had a material impact on our consolidated balance sheets, but did not have an impact on our consolidated income statements. The most significant impact was the recognition of ROU assets and lease liabilities for operating leases, while our accounting for finance leases remained substantially unchanged. Adoption of the standard required us to restate certain previously reported results, including the recognition of additional ROU assets and lease liabilities for operating leases. Refer to Impacts to Previously Reported Results below for the impact of adoption of the standard on our consolidated financial statements.

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Revenue from Contracts with Customers

In May 2014, the FASB issued a new standard related to revenue recognition. Under the standard, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

We elected to early adopt the standard effective July 1, 2017, using the full retrospective method, which required us to restate each prior reporting period presented. We implemented internal controls and key system functionality to enable the preparation of financial information on adoption.

The most significant impact of the standard relates to our accounting for software license revenue. Specifically, for Windows 10, we recognize revenue predominantly at the time of billing and delivery rather than ratably over the life of the related device. For certain multi-year commercial software subscriptions that include both distinct software licenses and SA, we recognize license revenue at the time of contract execution rather than over the subscription period. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard depends on contract-specific terms and in some instances may vary from recognition at the time of billing. Revenue recognition related to our hardware, cloud offerings (such as Office 365), LinkedIn, and professional services remains substantially unchanged.

Adoption of the standard using the full retrospective method required us to restate certain previously reported results, including the recognition of additional revenue and an increase in the provision for income taxes, primarily due to the net change in Windows 10 revenue recognition. In addition, adoption of the standard resulted in an increase in accounts receivable and other current and long-term assets, driven by unbilled receivables from upfront recognition of revenue for certain multi-year commercial software subscriptions that include both distinct software licenses and Software Assurance; a reduction of unearned revenue, driven by the upfront recognition of license revenue from Windows 10 and certain multi-year commercial software subscriptions; and an increase in deferred income taxes, driven by the upfront recognition of revenue. Refer to Impacts to Previously Reported Results below for the impact of adoption of the standard on our consolidated financial statements.

Impacts to Previously Reported Results

Adoption of the standards related to revenue recognition and leases impacted our previously reported results as follows:

(In millions, except per share amounts)	As Previously Reported	New Revenue Standard Adjustment	As Restated
Three Months Ended September 30, 2016			

Income Statements

Revenue	$ 20,453	$ 1,475	$ 21,928
Provision for income taxes	635	525	1,160
Net income	4,690	977	5,667
Diluted earnings per share	0.60	0.12	0.72

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(In millions)	As Previously Reported	New Revenue Standard Adjustment	New Lease Standard Adjustment	As Restated
June 30, 2017				
Balance Sheets				
Accounts receivable, net of allowance for doubtful accounts	$ 19,792	$ 2,639	$ 0	$ 22,431
Operating lease right-of-use assets	0	0	6,555	6,555
Other current and long-term assets	11,147	32	0	11,179
Unearned revenue	44,479	(17,823)	0	26,656
Deferred income taxes	531	5,203	0	5,734
Operating lease liabilities	0	0	5,372	5,372
Other current and long-term liabilities	23,464	(26)	1,183	24,621
Stockholders' equity	72,394	15,317	0	87,711

Adoption of the standards related to revenue recognition and leases had no impact to cash from or used in operating, financing, or investing on our consolidated cash flows statements.

Recent Accounting Guidance Not Yet Adopted

Financial Instruments – Targeted Improvements to Accounting for Hedging Activities

In August 2017, the FASB issued new guidance related to accounting for hedging activities. This guidance expands strategies that qualify for hedge accounting, changes how many hedging relationships are presented in the financial statements, and simplifies the application of hedge accounting in certain situations. The standard will be effective for us beginning July 1, 2019, with early adoption permitted for any interim or annual period before the effective date. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements, including accounting policies, processes, and systems.

Accounting for Income Taxes – Intra-Entity Asset Transfers

In October 2016, the FASB issued new guidance requiring an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than when the asset has been sold to an outside party. This guidance is effective for us beginning July 1, 2018, with early adoption permitted beginning July 1, 2017. We plan to adopt the guidance effective July 1, 2018. Adoption of the guidance will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. A cumulative-effect adjustment will capture the write-off of income tax consequences deferred from past intra-entity transfers involving assets other than inventory and new deferred tax assets for amounts not recognized under current U.S. GAAP. We anticipate this guidance will have a material impact on our consolidated balance sheets upon adoption, and continue to evaluate any impacts to our accounting policies, processes, and systems.

Financial Instruments – Credit Losses

In June 2016, the FASB issued a new standard to replace the incurred loss impairment methodology under current U.S. GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. We will be required to use a forward-looking expected credit loss model for accounts receivables, loans, and other financial instruments. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. The standard will be effective for us beginning July 1, 2020, with early adoption permitted beginning July 1, 2019. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date to align our credit loss methodology with the new standard. We are currently evaluating the impact of this standard on our consolidated financial statements, including accounting policies, processes, and systems.

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Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

In January 2016, the FASB issued a new standard related to certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the changes in the standard is the requirement for changes in the fair value of our equity investments, with certain exceptions, to be recognized through net income rather than other comprehensive income ("OCI"). The standard will be effective for us beginning July 1, 2018. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. A cumulative-effect adjustment will capture any previously held unrealized gains and losses related to our equity investments carried at fair value and the impact of recording the fair value of certain equity investments that were carried at cost. We are currently evaluating the impact of this standard on our consolidated financial statements, including accounting policies, processes, and systems.

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 were as follows:

(In millions, except per share amounts)

Three Months Ended September 30,	2017	2016
Net income available for common shareholders (A)	$6,576	$5,667
Weighted average outstanding shares of common stock (B)	7,708	7,789
Dilutive effect of stock-based awards	91	87
Common stock and common stock equivalents (C)	7,799	7,876
Earnings Per Share		
Basic (A/B)	$0.85	$0.73
Diluted (A/C)	$0.84	$0.72

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

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NOTE 3 — OTHER INCOME (EXPENSE), NET

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

(In millions)

Three Months Ended September 30,	2017	2016
Dividends and interest income	$473	$293
Interest expense	(672)	(437)
Net recognized gains on investments	573	405
Net losses on derivatives	(50)	(94)
Net losses on foreign currency remeasurements	(9)	(40)
Other, net	(39)	(15)
Total	$276	$112

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

(In millions)

Three Months Ended September 30,	2017	2016
Other-than-temporary impairments of investments	$(6)	$(18)
Realized gains from sales of available-for-sale securities	671	483
Realized losses from sales of available-for-sale securities	(92)	(60)
Total	$573	$405

NOTE 4 — INVESTMENTS

Investment Components

The components of investments, including associated derivatives, were as follows:

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
September 30, 2017							
Cash	$4,052	$0	$0	$4,052	$4,052	$0	$0
Mutual funds	1,040	0	0	1,040	1,040	0	0
Commercial paper	833	0	0	833	384	449	0
Certificates of deposit	1,430	0	0	1,430	1,252	178	0
U.S. government and agency securities	117,222	66	(344)	116,944	155	116,789	0
Foreign government bonds	5,150	2	(12)	5,140	1	5,139	0
Mortgage- and asset-backed securities	3,771	10	(4)	3,777	0	3,777	0
Corporate notes and bonds	4,872	62	(9)	4,925	0	4,925	0
Municipal securities	284	46	0	330	0	330	0
Common and preferred stock	2,220	2,604	(9)	4,815	0	0	4,815
Other investments	528	0	0	528	0	0	528
Total	$ 141,402	$ 2,790	$ (378)	$ 143,814	$ 6,884	$ 131,587	$ 5,343

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(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2017							
Cash	$3,624	$0	$0	$3,624	$3,624	$0	$0
Mutual funds	1,478	0	0	1,478	1,478	0	0
Commercial paper	319	0	0	319	69	250	0
Certificates of deposit	1,358	0	0	1,358	972	386	0
U.S. government and agency securities	112,119	85	(360)	111,844	16	111,828	0
Foreign government bonds	5,276	2	(13)	5,265	1,504	3,761	0
Mortgage- and asset-backed securities	3,921	14	(4)	3,931	0	3,931	0
Corporate notes and bonds	4,786	61	(12)	4,835	0	4,835	0
Municipal securities	284	43	0	327	0	327	0
Common and preferred stock	2,472	3,062	(34)	5,500	0	0	5,500
Other investments	523	0	0	523	0	0	523
Total	$ 136,160	$ 3,267	$ (423)	$ 139,004	$ 7,663	$ 125,318	$ 6,023

As of September 30, 2017 and June 30, 2017, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $1.0 billion and $1.1 billion, 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.

We lend certain fixed-income and equity securities to increase investment returns. These transactions are accounted for as secured borrowings and the loaned securities continue to be carried as investments on our consolidated balance sheets. 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. As of September 30, 2017 and June 30, 2017, collateral received under agreements for loaned securities was $4.9 billion and $3.7 billion, respectively, and was primarily comprised of U.S. government and agency securities.

Unrealized Losses on Investments

Investments with continuous unrealized losses for less than 12 months and 12 months or greater and their related fair values were as follows:

	Less than 12 Months	12 Months or Greater

(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
September 30, 2017						
U.S. government and agency securities	$98,245	$(290)	$4,957	$(54)	$103,202	$(344)
Foreign government bonds	4,972	(1)	24	(11)	4,996	(12)
Mortgage- and asset-backed securities	713	(2)	236	(2)	949	(4)
Corporate notes and bonds	502	(4)	283	(5)	785	(9)
Common and preferred stock	30	0	59	(9)	89	(9)
Total	$ 104,462	$ (297)	$ 5,559	$ (81)	$ 110,021	$ (378)

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(In millions)	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2017						
U.S. government and agency securities	$87,558	$(348)	$371	$(12)	$87,929	$(360)
Foreign government bonds	4,006	(2)	23	(11)	4,029	(13)
Mortgage- and asset-backed securities	1,068	(3)	198	(1)	1,266	(4)
Corporate notes and bonds	669	(8)	177	(4)	846	(12)
Common and preferred stock	69	(6)	148	(28)	217	(34)
Total	$93,370	$ (367)	$ 917	$ (56)	$ 94,287	$ (423)

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.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
September 30, 2017		
Due in one year or less	$22,611	$22,558
Due after one year through five years	101,909	101,734
Due after five years through 10 years	8,121	8,145
Due after 10 years	921	942
Total	$ 133,562	$ 133,379

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, Canadian dollar, and Australian dollar. As of September 30, 2017 and June 30, 2017, the total notional amounts of these foreign exchange contracts sold were $8.9 billion for both periods.

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 September 30, 2017 and June 30, 2017, the total notional amounts of these foreign exchange contracts sold were $5.0 billion and $5.1 billion, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures. As of September 30, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were $11.0

billion and $8.2 billion, respectively. As of June 30, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were $8.8 billion and $10.6 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 instruments, including puts, calls, swaps, and forwards. As of September 30, 2017, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.6 billion and $2.6 billion, respectively, of which $1.6 billion and $1.8 billion, respectively, were designated as hedging instruments. As of June 30, 2017, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.9 billion and $2.4 billion, respectively, of which $1.6 billion and $1.8 billion, respectively, were designated as hedging instruments.

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 September 30, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were $528 million and $364 million, respectively. As of June 30, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were $233 million and $352 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 September 30, 2017 and June 30, 2017, the total notional derivative amounts of mortgage contracts purchased were $553 million and $567 million, 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 September 30, 2017, the total notional amounts of credit contracts purchased and sold were $252 million and $49 million, respectively. As of June 30, 2017, the total notional amounts of credit contracts purchased and sold were $267 million and $63 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 September 30, 2017, 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 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.

For derivative instruments that are not designated as hedges, gains (losses) from changes in fair values are primarily recognized in other income (expense), net. Other than those derivatives entered into for investment purposes, 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 reclassified from accumulated other comprehensive income ("AOCI") into other income (expense), net.

The following table presents 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:

	Assets				Liabilities	
(In millions)	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Long-term Assets	Other Current Liabilities	Other Long-term Liabilities
September 30, 2017						
Non-designated Hedge Derivatives						
Foreign exchange contracts	$10	$93	$0	$14	$(83)	$(7)
Equity contracts	5	0	0	0	(16)	0
Interest rate contracts	4	0	0	0	(8)	0
Credit contracts	4	0	0	0	(1)	0
Total	$23	$93	$0	$14	$(108)	$(7)
Designated Hedge Derivatives						
Foreign exchange contracts	$81	$89	$0	$6	$(3)	$0
Equity contracts	0	0	23	0	(337)	0

Total	$81	$89	$ 23	$ 6	$(340)	$ 0
Total gross amounts of derivatives	$104	$182	$ 23	$ 20	$(448)	$ (7)
Gross derivatives either offset or subject to an enforceable master netting agreement	$104	$182	$ 23	$ 20	$(444)	$ (7)
Gross amounts of derivatives offset on the balance sheet	(18)	(92)	(23)	(7)	133	7
Net amounts presented on the balance sheet	86	90	0	13	(311)	0
Gross amounts of derivatives not offset on the balance sheet	0	0	0	0	0	0
Cash collateral received	0	0	0	0	(134)	0
Net amount	$86	$90	$ 0	$ 13	$ (445)	$ 0

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(In millions)	Assets: Short-term Investments	Assets: Other Current Assets	Assets: Equity and Other Investments	Assets: Other Long-term Assets	Liabilities: Other Current Liabilities	Liabilities: Other Long-term Liabilities
June 30, 2017						
Non-designated Hedge Derivatives						
Foreign exchange contracts	$9	$203	$ 0	$ 6	$ (134)	$ (8)
Equity contracts	3	0	0	0	(6)	0
Interest rate contracts	3	0	0	0	(7)	0
Credit contracts	5	0	0	0	(1)	0
Total	$20	$203	$ 0	$ 6	$ (148)	$ (8)
Designated Hedge Derivatives						
Foreign exchange contracts	$80	$133	$ 0	$ 0	$ (3)	$ 0
Equity contracts	0	0	67	0	(186)	0
Total	$80	$133	$ 67	$ 0	$ (189)	$ 0
Total gross amounts of derivatives	$100	$336	$ 67	$ 6	$ (337)	$ (8)
Gross derivatives either offset or subject to an enforceable master netting agreement	$100	$336	$ 67	$ 6	$ (334)	$ (8)
Gross amounts of derivatives offset on the balance sheet	(20)	(132)	(67)	(8)	221	7
Net amounts presented on the balance sheet	80	204	0	(2)	(113)	(1)
Gross amounts of derivatives not offset on the balance sheet	0	0	0	0	0	0
Cash collateral received	0	0	0	0	(228)	0

Net amount	$80	$204	$ 0	$ (2)	$ (341)	$ (1)

Refer to Note 4 – Investments and Note 6 – Fair Value Measurements for further information.

Fair Value Hedge Gains (Losses)

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

(In millions)

Three Months Ended September 30,	2017	2016
Foreign Exchange Contracts		
Derivatives	$ 22	$(48)
Hedged items	(2)	68
Total amount of ineffectiveness	$20	$20
Equity Contracts		
Derivatives	$(236)	$ (10)
Hedged items	236	10
Total amount of ineffectiveness	$0	$0
Amount of equity contracts excluded from effectiveness assessment	$40	$(3)

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Cash Flow Hedge Gains (Losses)

We recognized the following gains (losses) on foreign exchange contracts designated as cash flow hedges:

(In millions)		
Three Months Ended September 30,	2017	2016
Effective Portion		
Gains recognized in other comprehensive income (net of tax of $0 and $1)	$ 5	$ 35
Gains reclassified from accumulated other comprehensive income into revenue	111	75
Amount Excluded from Effectiveness Assessment and Ineffective Portion		
Losses recognized in other income (expense), net	(91)	(70)

We estimate that $29 million of net derivative gains included in AOCI as of September 30, 2017 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 months ended September 30, 2017.

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), net. 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), net, which were immaterial for the periods presented. Other than those derivatives entered into for investment purposes, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities and gains (losses) from foreign exchange rate changes on certain balance sheet amounts.

(In millions)

Three Months Ended September 30,	2017	2016
Foreign exchange contracts	$(69)	$(31)
Equity contracts	(29)	(17)
Interest-rate contracts	11	4
Credit contracts	0	2
Other contracts	0	(22)
Total	$(87)	$(64)

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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 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. Our Level 2 non-derivative investments consist primarily of foreign government bonds, corporate notes and bonds, mortgage- and asset-backed securities, U.S. government and agency securities, certificates of deposit, and common and preferred stock. 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 models and discounted cash flow models. Our Level 3 non-derivative assets and liabilities primarily comprise investments in common and preferred stock, and goodwill and intangible assets, when they are recorded at fair value due to an impairment charge. Unobservable inputs used in the 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 current financial liabilities have fair values that approximate their carrying values.

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Financial 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)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [a]	Net Fair Value
September 30, 2017						
Assets						
Mutual funds	$1,040	$0	$0	$1,040	$0	$1,040
Commercial paper	0	833	0	833	0	833
Certificates of deposit	0	1,430	0	1,430	0	1,430
U.S. government and agency securities	114,965	1,979	0	116,944	0	116,944
Foreign government bonds	16	5,042	0	5,058	0	5,058
Mortgage- and asset-backed securities	0	3,781	0	3,781	0	3,781
Corporate notes and bonds	0	4,915	1	4,916	0	4,916
Municipal securities	0	330	0	330	0	330
Common and preferred stock	2,429	1,346	18	3,793	0	3,793
Derivatives	2	327	0	329	(140)	189
Total	$ 118,452	$ 19,983	$19	$ 138,454	$ (140)	$ 138,314
Liabilities						
Derivatives and other	$16	$439	$38	$493	$(140)	$353

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [a]	Net Fair Value
June 30, 2017						
Assets						
Mutual funds	$1,478	$0	$0	$1,478	$0	$1,478

Commercial paper	0	319	0	319	0	319
Certificates of deposit	0	1,358	0	1,358	0	1,358
U.S. government and agency securities	109,228	2,616	0	111,844	0	111,844
Foreign government bonds	0	5,187	0	5,187	0	5,187
Mortgage- and asset-backed securities	0	3,934	0	3,934	0	3,934
Corporate notes and bonds	0	4,829	1	4,830	0	4,830
Municipal securities	0	327	0	327	0	327
Common and preferred stock	2,414	1,994	18	4,426	0	4,426
Derivatives	1	508	0	509	(227)	282
Total	$ 113,121	$ 21,072	$ 19	$ 134,212	$ (227)	$ 133,985
Liabilities						
Derivatives and other	$ 0	$ 345	$ 39	$ 384	$ (228)	$ 156

(a) 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 changes in our Level 3 financial instruments that are measured at fair value on a recurring basis were immaterial during the periods presented.

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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)	September 30, 2017	June 30, 2017
Net fair value of assets measured at fair value on a recurring basis	$138,314	$133,985
Cash	4,052	3,624
Common and preferred stock measured at fair value on a nonrecurring basis	1,020	1,073
Other investments measured at fair value on a nonrecurring basis	528	523
Less derivative net assets classified as other current and long-term assets	(103)	(202)
Other	3	1
Recorded basis of investment components	$ 143,814	$ 139,004

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

During the three months ended September 30, 2017 and 2016, 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)	September 30, 2017	June 30, 2017
Raw materials	$ 766	$797

Work in process	112	145
Finished goods	2,333	1,239
Total	$ 3,211	$ 2,181

NOTE 8 — BUSINESS COMBINATIONS

On December 8, 2016, we completed our acquisition of all issued and outstanding shares of LinkedIn Corporation, the world's largest professional network on the Internet, for a total purchase price of $27.0 billion. The purchase price consisted primarily of cash of $26.9 billion. The acquisition is expected to accelerate the growth of LinkedIn, Office 365, and Dynamics 365. The financial results of LinkedIn have been included in our consolidated financial statements since the date of the acquisition.

NOTE 9 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30, 2017	Acquisitions	Other	September 30, 2017
Productivity and Business Processes	$23,739	$ 0	$51	$ 23,790
Intelligent Cloud	5,555	68	(2)	5,621
More Personal Computing	5,828	57	93	5,978
Total	$ 35,122	$ 125	$ 142	$ 35,389

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 change in the amounts allocated to goodwill during the periods in which the adjustments are determined.

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Any change in the goodwill amounts resulting from foreign currency translations and purchase accounting adjustments are presented as "Other" in the above table. Also included in "Other" are business dispositions and transfers between business segments due to reorganizations, as applicable.

NOTE 10 — INTANGIBLE ASSETS

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

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
	September 30, 2017			June 30, 2017		
Technology-based [(a)]	$7,833	$ (4,686)	$ 3,147	$7,765	$ (4,318)	$3,447
Marketing-related	4,040	(902)	3,138	4,016	(829)	3,187
Contract-based	819	(725)	94	841	(722)	119
Customer-related	4,049	(830)	3,219	4,045	(692)	3,353
Total	$ 16,741	$ (7,143)	$ 9,598	$ 16,667	$ (6,561)	$ 10,106

(a) Technology-based intangible assets included $46 million and $59 million of net carrying amount of software to be sold, leased, or otherwise marketed as of September 30, 2017 and June 30, 2017, respectively.

Intangible assets amortization expense was $563 million and $214 million for the three months ended September 30, 2017 and 2016, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held as of September 30, 2017:

(In millions)	
Year Ending June 30,	
2018 (excluding the three months ended September 30, 2017)	$1,661

2019	1,701
2020	1,193
2021	1,006
2022	934
Thereafter	3,103
Total	$ 9,598

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NOTE 11 — DEBT

Short-term Debt

As of September 30, 2017, we had $8.2 billion of commercial paper issued and outstanding, with a weighted average interest rate of 1.20% and maturities ranging from 34 days to 196 days. As of June 30, 2017, we had $9.1 billion of commercial paper issued and outstanding, with a weighted average interest rate of 1.01% and maturities ranging from 25 days to 264 days. The estimated fair value of this commercial paper approximates its carrying value.

We have two $5.0 billion credit facilities that expire on October 31, 2017 and November 14, 2018, respectively. We expect to enter into two new $5.0 billion credit facilities in October 2017 which will replace each of our existing facilities. These credit facilities serve as a back-up for our commercial paper program. As of September 30, 2017, we were in compliance with the only financial covenant in both credit agreements, 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 agreements. No amounts were drawn against these credit facilities during any of the periods presented.

Long-term Debt

As of September 30, 2017, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $77.3 billion and $81.3 billion, respectively. As of June 30, 2017, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $77.1 billion and $80.3 billion, respectively. 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:

(In millions, except interest rates)	Face Value September 30, 2017	Face Value June 30, 2017	Stated Interest Rate	Effective Interest Rate
Notes				
November 15, 2017	$ 600	$ 600	0.875%	1.084%
May 1, 2018	450	450	1.000%	1.106%
November 3, 2018	1,750	1,750	1.300%	1.396%
December 6, 2018	1,250	1,250	1.625%	1.824%
June 1, 2019	1,000	1,000	4.200%	4.379%
August 8, 2019	2,500	2,500	1.100%	1.203%
November 1, 2019	18	18	0.500%	0.500%
February 6, 2020	1,500	1,500	1.850%	1.952%
February 12, 2020	1,500	1,500	1.850%	1.935%
October 1, 2020	1,000	1,000	3.000%	3.137%
November 3, 2020	2,250	2,250	2.000%	2.093%
February 8, 2021	500	500	4.000%	4.082%
August 8, 2021	2,750	2,750	1.550%	1.642%
December 6, 2021 (a)	2,069	1,996	2.125%	2.233%
February 6, 2022	1,750	1,750	2.400%	2.520%
February 12, 2022	1,500	1,500	2.375%	2.466%
November 3, 2022	1,000	1,000	2.650%	2.717%
November 15, 2022	750	750	2.125%	2.239%
May 1, 2023	1,000	1,000	2.375%	2.465%
August 8, 2023	1,500	1,500	2.000%	2.101%

December 15, 2023	1,500	1,500	3.625%	3.726%
February 6, 2024	2,250	2,250	2.875%	3.041%
February 12, 2025	2,250	2,250	2.700%	2.772%
November 3, 2025	3,000	3,000	3.125%	3.176%
August 8, 2026	4,000	4,000	2.400%	2.464%
February 6, 2027	4,000	4,000	3.300%	3.383%
December 6, 2028 [(a)]	2,069	1,996	3.125%	3.218%
May 2, 2033 [(a)]	651	627	2.625%	2.690%
February 12, 2035	1,500	1,500	3.500%	3.604%
November 3, 2035	1,000	1,000	4.200%	4.260%
August 8, 2036	2,250	2,250	3.450%	3.510%
February 6, 2037	2,500	2,500	4.100%	4.152%
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	500	500	4.875%	4.918%
February 12, 2045	1,750	1,750	3.750%	3.800%
November 3, 2045	3,000	3,000	4.450%	4.492%
August 8, 2046	4,500	4,500	3.700%	3.743%
February 6, 2047	3,000	3,000	4.250%	4.287%
February 12, 2055	2,250	2,250	4.000%	4.063%
November 3, 2055	1,000	1,000	4.750%	4.782%
August 8, 2056	2,250	2,250	3.950%	4.033%
February 6, 2057	2,000	2,000	4.500%	4.528%
Total	$ 78,007	$ 77,837		

(a) Euro-denominated debt securities.

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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 September 30, 2017 and June 30, 2017, the aggregate debt issuance costs and unamortized discount associated with our long-term debt, including the current portion, were $702 million and $715 million, respectively.

NOTE 12 — INCOME TAXES

Our effective tax rate for the three months ended September 30, 2017 and 2016 was 18% and 17%, 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 increase in our effective tax rate compared to the prior year was primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries.

Tax contingencies and other income tax liabilities were $13.9 billion and $13.5 billion as of September 30, 2017 and June 30, 2017, respectively, and are included in other long-term liabilities. This increase relates primarily to current period intercompany transfer pricing.

While we settled a portion of the Internal Revenue Service ("IRS") audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and settled a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. We also continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of September 30, 2017, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

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 2017, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

NOTE 13 — RESTRUCTURING CHARGES

In June 2017, management approved a sales and marketing restructuring plan. In fiscal year 2017, we recorded employee severance expenses of $306 million primarily related to this sales and marketing restructuring plan. We do not expect to incur additional charges for this restructuring plan in subsequent years. The actions associated with this restructuring plan are expected to be completed by the end of fiscal year 2018.

Changes in the restructuring liability were as follows:

(In millions)	Severance	Other (a)	Total
Balance, as of June 30, 2017	$373	$59	$432
Restructuring charges	0	0	0
Cash paid	(179)	(5)	(184)
Balance, as of September 30, 2017	$194	$54	$248

(a) Primarily reflects activities associated with the consolidation of our phone facilities, manufacturing operations, and contract termination costs.

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NOTE 14 — UNEARNED REVENUE

Unearned revenue by segment was as follows:

(In millions)	September 30, 2017	June 30, 2017
Productivity and Business Processes	$ 11,808	$12,692
Intelligent Cloud	10,156	11,152
More Personal Computing	2,940	2,812
Total	$ 24,904	$26,656

The opening balance of unearned revenue was $22.2 billion as of July 1, 2016.

Changes in unearned revenue were as follows:

(In millions)	
Three Months Ended September 30, 2017	
Balance, beginning of period	$26,656
Deferral of revenue	10,988
Recognition of unearned revenue	(12,740)
Balance, end of period	$ 24,904

Revenue allocated to remaining performance obligations represent contracted revenue that has not yet been recognized (“contracted not recognized”), which includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. Contracted not recognized revenue was $59 billion as of September 30, 2017, of which we expect to recognize approximately 60% of the revenue over the next 12 months and the remainder thereafter.

NOTE 15 — LEASES

We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which may include options to extend the leases for up to 5 years, and some of which may include options to terminate the leases within 1 year. As of September 30, 2017 and June 30, 2017, assets recorded under finance leases were $3.4 billion and $2.7 billion, respectively, and accumulated depreciation associated with finance leases was $209 million and $161 million, respectively.

The components of lease expense were as follows:

(In millions)

Three Months Ended September 30,	2017	2016
Operating lease cost	$388	$260
Finance lease cost		
Amortization of right-of-use assets	$48	$15
Interest on lease liabilities	30	12
Total finance lease cost	$78	$ 27

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Other information related to leases was as follows:

(In millions, except lease term and discount rate)

Three Months Ended September 30,	2017	2016
Supplemental Cash Flows Information		
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	$369	$267
Operating cash flows from finance leases	30	12
Financing cash flows from finance leases	25	6
Right-of-use assets obtained in exchange for lease obligations:		
Operating leases	391	55
Finance leases	728	267
Weighted Average Remaining Lease Term		
Operating leases	7 years	5 years
Finance leases	14 years	12 years
Weighted Average Discount Rate		
Operating leases	2.5%	2.3%
Finance leases	4.7%	5.1%

Future minimum lease payments under non-cancellable leases as of September 30, 2017 were as follows:

(In millions)

Year Ending June 30,	Operating Leases	Finance Leases
2018 (excluding the three months ended September 30, 2017)	$ 1,110	$205
2019	1,385	281
2020	1,267	287
2021	1,022	293
2022	833	299
Thereafter	2,333	3,133

Total future minimum lease payments	7,950	4,498
Less imputed interest	(930)	(1,225)
Total	$ 7,020	$ 3,273
Reported as of September 30, 2017		
Other current liabilities	$ 1,252	$ 146
Operating lease liabilities	5,768	0
Other long-term liabilities	0	3,127
Total	$ 7,020	$ 3,273

As of September 30, 2017, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $219 million and $2.3 billion, respectively. These operating and finance leases will commence between fiscal year 2018 and fiscal year 2019 with lease terms of 1 year to 20 years.

NOTE 16 — CONTINGENCIES

Patent and Intellectual Property Claims

IPCom Patent Litigation

IPCom GmbH & Co. (“IPCom”) is a German company that holds a large portfolio of mobile technology-related patents spanning about 170 patent families and addressing a broad range of cellular technologies. IPCom has asserted 19 of these patents in litigation against Nokia Corporation (“Nokia”) and many of the leading cellular phone companies and operators. In November 2014, Microsoft and IPCom entered into a standstill agreement staying all of the pending litigation against Microsoft to permit the parties to pursue settlement discussions, which continue.

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European Copyright Levies

We assumed from Nokia all potential liability due to Nokia's alleged failure to pay "private copyright levies" in various European countries based upon sale of memory cards and mobile phones that incorporate blank memory. The levies are based upon a 2001 European Union ("EU") directive establishing a right for end users to make copies of copyrighted works for personal or private use, but also allowing the collection of levies based upon sales of blank media or recording devices to compensate copyright holders for private copying. Various collecting societies in EU countries initiated litigation against Nokia, stating it must pay levies not only based upon sales of blank memory cards, but also phones that include blank memory for data storage on the phones, regardless of actual usage of that memory. The most significant cases against Nokia were pending in Germany and Austria, due to both the high volume of sales and high levy amounts sought in these countries. We reached a settlement of the Austrian case in August 2016. In July 2016, the German Supreme Court heard our appeal contesting the legality of the levy assessed on phones with music players and over five megabytes of memory. The Supreme Court issued a ruling in December 2016, finding that the levy may not be appropriate for phones that have the ability to receive music files only via Bluetooth or infrared inputs, and remanded for further proceedings. We reached a final settlement of the pending cases in October 2017.

Other Patent and Intellectual Property Claims

In addition to the IPCom cases, there were 40 other patent infringement cases pending against Microsoft as of September 30, 2017.

Antitrust, Unfair Competition, and Overcharge Class Actions

Antitrust and unfair competition class action lawsuits were filed against us in British Columbia, Ontario, and Quebec, Canada. All three have been certified on behalf of Canadian indirect purchasers who acquired licenses for Microsoft operating system software and/or productivity application software between 1998 and 2010.

The trial of the British Columbia action commenced in May 2016. The plaintiffs filed their case in chief in August 2016, setting out claims made, authorities, and evidence in support of their claims. A six-month oral hearing is expected to begin in summer 2018, consisting of cross examination on witness affidavits. The Ontario and Quebec cases are inactive.

Other Antitrust Litigation and Claims

China State Administration for Industry and Commerce Investigation

In 2014, Microsoft was informed that China's State Administration for Industry and Commerce ("SAIC") had begun a formal investigation relating to China's Anti-Monopoly Law, and the SAIC conducted onsite inspections of Microsoft offices in Beijing, Shanghai, Guangzhou, and Chengdu. SAIC has stated the investigation relates to compatibility, bundle sales, file verification issues related to Windows and Office software, and potentially other issues.

Product-Related Litigation

U.S. Cell Phone Litigation

Nokia, along with other handset manufacturers and network operators, is a defendant in 19 lawsuits filed in the Superior Court for the District of Columbia by individual plaintiffs who allege that radio emissions from cellular handsets caused their brain tumors and other adverse health effects. We assumed responsibility for these claims in our agreement to acquire Nokia's Devices and Services business and have been substituted for the Nokia defendants. Nine of these cases were filed in 2002 and are consolidated for certain pre-trial proceedings; the remaining 10 cases are stayed. In a separate 2009 decision, the Court of Appeals for the District of Columbia held that adverse health effect claims arising from the use of cellular handsets that operate within the U.S. Federal Communications Commission radio frequency emission guidelines ("FCC Guidelines") are pre-empted by federal law. The plaintiffs allege that their handsets either operated outside the FCC Guidelines or were manufactured before the FCC Guidelines went into effect. The lawsuits also allege an industry-wide conspiracy to manipulate the science and testing around emission guidelines.

In 2013, defendants in the consolidated cases moved to exclude plaintiffs' expert evidence of general causation on the basis of flawed scientific methodologies. In 2014, the trial court granted in part and denied in part defendants' motion to exclude plaintiffs' general causation experts. The defendants filed an interlocutory appeal challenging the standard for evaluating expert scientific evidence, which the District of Columbia Court of Appeals heard en banc. In October 2016, the Court of Appeals issued its decision adopting the standard advocated by defendants and remanding the cases to the trial court for further proceedings under that standard. Plaintiffs have filed supplemental expert evidence, portions of which defendants have moved to strike.

Canadian Cell Phone Class Action

Nokia, along with other handset manufacturers and network operators, is a defendant in a 2013 class action lawsuit filed in the Supreme Court of British Columbia by a purported class of Canadians who have used cellular phones for at least 1,600 hours, including a subclass of users with brain tumors, alleging adverse health effects from cellular phone use. Microsoft was served with the complaint in June 2014 and has been substituted for the Nokia defendants. The litigation has been dormant for more than three years.

Other Contingencies

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 consolidated financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

As of September 30, 2017, we accrued aggregate legal liabilities of $371 million. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $1.1 billion 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 consolidated financial statements for the period in which the effects become reasonably estimable.

NOTE 17 — STOCKHOLDERS' EQUITY

Share Repurchases

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to $40.0 billion in share repurchases. This share repurchase program became effective on October 1, 2013, and was completed on December 22, 2016.

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing up to an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of September 30, 2017, $35.2 billion remained of this $40.0 billion share repurchase program.

We repurchased the following shares of common stock under the share repurchase programs:

(In millions)	Shares	Amount	Shares	Amount
Fiscal Year		2018		2017
First Quarter	22	$1,600	63	$3,550

Shares repurchased during the first quarter of fiscal year 2018 were under the share repurchase program approved September 20, 2016. Shares repurchased during the first quarter of fiscal year 2017 were under the share repurchase program approved September 16, 2013. The above table excludes shares repurchased to settle employee tax withholding related to the vesting of stock awards. All repurchases were made using cash resources.

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Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(in millions)	
September 19, 2017	$ 0.42	November 16, 2017	$ 3,242	December 14, 2017
September 20, 2016	$ 0.39	November 17, 2016	$ 3,024	December 8, 2016

The dividend declared on September 19, 2017 was included in other current liabilities as of September 30, 2017.

NOTE 18 — ACCUMULATED OTHER COMPREHENSIVE INCOME

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

(In millions)		
Three Months Ended September 30,	2017	2016
Derivatives		
Balance, beginning of period	$134	$352
Unrealized gains, net of tax of $0 and $1	4	35
Reclassification adjustments for gains included in revenue	(111)	(75)
Tax expense included in provision for income taxes	1	3
Amounts reclassified from accumulated other comprehensive income	(110)	(72)
Net change related to derivatives, net of tax of $(1) and $(2)	(106)	(37)

Balance, end of period	$28	$315
Investments		
Balance, beginning of period	$1,825	$2,941
Unrealized gains, net of tax effects of $50 and $182	73	339
Reclassification adjustments for gains included in other income (expense), net	(555)	(394)
Tax expense included in provision for income taxes	194	138
Amounts reclassified from accumulated other comprehensive income	(361)	(256)
Net change related to investments, net of tax of $(144) and $44	(288)	83
Balance, end of period	$1,537	$3,024
Translation Adjustments and Other		
Balance, beginning of period	$(1,332)	$(1,499)
Translation adjustments and other, net of tax of $(1) and $7	293	118
Balance, end of period	$ (1,039)	$(1,381)
Accumulated other comprehensive income, end of period	$526	$1,958

NOTE 19 — SEGMENT INFORMATION AND GEOGRAPHIC DATA

In its operation of the business, management, including our chief operating decision maker, who is also our Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. During the periods presented, we reported our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing.

Our reportable segments are described below.

Productivity and Business Processes

Our Productivity and Business Processes segment consists of products and services in our portfolio of productivity, communication, and information services, spanning a variety of devices and platforms. This segment primarily comprises:

- Office Commercial, including Office 365 subscriptions and Office licensed on-premises, comprising Office, Exchange, SharePoint, Skype for Business, and Microsoft Teams, and related Client Access Licenses ("CALs").
- Office Consumer, including Office 365 subscriptions and Office licensed on-premises, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.
- LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.
- Dynamics business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.

Intelligent Cloud

Our Intelligent Cloud segment consists of our public, private, and hybrid server products and cloud services that can power modern business. This segment primarily comprises:

- Server products and cloud services, including Microsoft SQL Server, Windows Server, Visual Studio, System Center, and related CALs, and Azure.
- Enterprise Services, including Premier Support Services and Microsoft Consulting Services.

More Personal Computing

Our More Personal Computing segment consists of products and services geared towards harmonizing the interests of end users, developers, and IT professionals across all devices. This segment primarily comprises:

- Windows, including Windows original equipment manufacturer licensing and other non-volume licensing of the Windows operating system; Windows Commercial, comprising volume licensing of the Windows operating system, Windows cloud services, and other Windows commercial offerings; patent licensing; Windows Internet of Things ("IoT"); and MSN display advertising.
- Devices, including Microsoft Surface, PC accessories, and other intelligent devices.
- Gaming, including Xbox hardware and Xbox software and services, comprising Xbox Live transactions, subscriptions, and advertising ("Xbox Live"), video games, and third-party video game royalties.
- Search advertising.

Revenue and costs are generally directly attributed to our segments. However, due to the integrated structure of our business, certain revenue recognized and costs incurred by one segment may benefit other segments. Revenue from certain contracts is allocated among the segments based on the relative value of the underlying products and services, which can include allocation based on actual prices charged, prices when sold separately, or estimated costs plus a profit margin. Cost of revenue is allocated in certain cases based on a relative revenue methodology. Operating expenses that are allocated primarily include those relating to marketing of products and services from which multiple segments benefit, and are generally allocated based on relative gross margin.

In addition, certain costs incurred at a corporate level that are identifiable and that benefit our segments are allocated to them. These allocated costs include costs of: legal, including settlements, and fines; information technology; human resources; finance; excise taxes; field selling; shared facilities services; and customer service and support. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated. Certain corporate-level activity is not allocated to our segments, including impairment, integration, and restructuring expenses.

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Segment revenue and operating income were as follows during the periods presented:

(In millions)		
Three Months Ended September 30,	2017	2016
Revenue		
Productivity and Business Processes	$8,238	$6,436
Intelligent Cloud	6,922	6,097
More Personal Computing	9,378	9,395
Total	$24,538	$21,928
Operating Income		
Productivity and Business Processes	$3,006	$2,905
Intelligent Cloud	2,137	1,777
More Personal Computing	2,565	2,033
Total	$7,708	$6,715

No sales to an individual customer or country other than the United States accounted for more than 10% of revenue for the three months ended September 30, 2017 or 2016. Revenue, classified by the major geographic areas in which our customers are located, was as follows:

(In millions)		
Three Months Ended September 30,	2017	2016
United States [(a)]	$12,527	$11,215
Other countries	12,011	10,713
Total	$24,538	$21,928

(a) Includes billings to original equipment manufacturers and certain multinational organizations because of the nature of these businesses and the impracticability of determining the geographic source of the revenue.

Revenue from external customers, classified by significant product and service offerings, was as follows:

(In millions)		
Three Months Ended September 30,	2017	2016
Office products and cloud services	$6,575	$5,982
Server products and cloud services	5,496	4,689
Windows	4,643	4,643
Gaming	1,896	1,885
Search advertising	1,639	1,429
Enterprise Services	1,371	1,355
Devices	1,154	1,362
LinkedIn	1,148	0
Other	616	583
Total	$24,538	$21,928

Our total commercial cloud revenue, which primarily comprises Office 365 commercial, Azure, Dynamics 365, and other cloud properties, was $5.0 billion and $3.2 billion for the three months ended September 30, 2017 and 2016, respectively. These amounts are primarily included in Office products and cloud services and server products and cloud services in the table above.

Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each 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 "Company") as of September 30, 2017, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the three-month periods ended September 30, 2017 and 2016. These interim financial statements are the responsibility of the Company'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 the Company as of June 30, 2017, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the year then ended prior to retrospective adjustment for the changes in the Company's method of accounting for revenue from contracts with customers and for leases, (not presented herein); and in our report dated August 2, 2017, we expressed an unqualified opinion on those consolidated financial statements. We also audited the adjustments described in Note 1 that were applied to retrospectively adjust the June 30, 2017 consolidated balance sheet of Microsoft Corporation and subsidiaries. In our opinion, such adjustments are appropriate and have been properly applied to the previously issued consolidated balance sheet in deriving the accompanying retrospectively adjusted consolidated balance sheet as of June 30, 2017.

/S/ DELOITTE & TOUCHE LLP

Seattle, Washington

October 26, 2017

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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 of Financial Condition and Results of Operations" (Part I, Item 2 of this Form 10-Q) and "Risk Factors" (Part II, Item 1A of this Form 10-Q). These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "future," "opportunity," "plan," "may," "should," be," "will continue," "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," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and "Quantitative and Qualitative Disclosures about Market Risk" (Part I, Item 3 of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("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, 2017, and our financial statements and the accompanying Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

OVERVIEW

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our strategy is to build best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence. We develop, license, and support a wide range of software products, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people's lives. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

We generate revenue by licensing and supporting an array of software products, by offering a wide range of cloud-based and other 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; datacenter costs in support of our cloud-based services; and income taxes.

Highlights from the first quarter of fiscal year 2018 included:

- Commercial cloud annualized revenue run rate* reached $20.4 billion.
- Office Commercial revenue increased 10%, driven by Microsoft Office 365 commercial revenue growth of 42%.
- Office Consumer revenue increased 12%, and Office 365 consumer subscribers increased to 28.0 million.

- Microsoft Dynamics revenue increased 13%, driven by Dynamics 365 revenue growth of 69%.
- LinkedIn contributed revenue of $1.1 billion.
- Server products and cloud services revenue increased 17%, driven by Microsoft Azure revenue growth of 90%.
- Enterprise Services revenue increased 1%, driven by higher revenue from Premier Support Services, offset in part by a decline in revenue from custom support agreements.
- Windows original equipment manufacturer licensing ("Windows OEM") revenue increased 4%, ahead of the overall PC market.

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- Windows Commercial revenue increased 7%, driven by multi-year agreement revenue growth.
- Search advertising revenue, excluding traffic acquisition costs, increased 15%, driven by higher revenue per search and search volume.
- Microsoft Surface revenue increased 12%, driven by sales of the new Surface Laptop.
- Gaming revenue increased 1%, driven by Xbox software and services revenue growth of 21%, offset in part by lower Xbox hardware revenue.

* Commercial cloud annualized revenue run rate is calculated by multiplying revenue for the last month of the quarter by twelve for Office 365 commercial, Azure, Dynamics 365, and other cloud properties.

We adopted the new accounting standards for revenue recognition and leases effective July 1, 2017. These new standards had a material impact on our consolidated financial statements. Beginning with the first quarter of fiscal year 2018, our financial results reflect adoption of the standards with prior periods restated accordingly. Refer to Note 1 – Accounting Policies in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

On December 8, 2016, we completed our acquisition of LinkedIn Corporation for a total purchase price of $27.0 billion. LinkedIn has been included in our consolidated results of operations since the date of acquisition. Refer to Note 8 – Business Combinations in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

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 and users, industry trends, and competitive forces.

Economic Conditions, Challenges, and Risks

The markets for software, devices, and cloud-based services are dynamic and highly competitive. Our competitors are developing new software and devices, while also 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. We must continue to evolve and adapt over an extended time in pace with this changing environment. The investments we are making in infrastructure and devices will continue to increase our operating costs and may decrease our operating margins.

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 globally by offering an exceptional working environment, broad customer reach, scale in resources, the ability to grow one’s career across many different products and businesses, and competitive compensation and benefits. Aggregate demand for our software, services, and devices is correlated to global macroeconomic and geopolitical factors, which remain dynamic.

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. Strengthening of the U.S. dollar relative to certain foreign currencies throughout fiscal year 2017 negatively impacted reported revenue and reduced reported expenses from our international operations. This trend has reversed in fiscal year 2018 and foreign currencies strengthening relative to the U.S. dollar have positively impacted our financial results.

Refer to Risk Factors (Part II, Item 1A of this Form 10-Q) for a discussion of these factors and other risks.

Seasonality

We expect our revenue to fluctuate quarterly and to be higher in the second and fourth quarters of our fiscal year. Second quarter revenue is driven by corporate year-end spending trends in our major markets and holiday season spending by consumers, and fourth quarter revenue is driven by the volume of multi-year on-premises contracts executed during the period.

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Reportable Segments

We report our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. The segment amounts included in MD&A are presented on a basis consistent with our internal management reporting. All differences between our internal management reporting basis and accounting principles generally accepted in the United States ("U.S. GAAP"), along with certain corporate-level and other activity, are included in Corporate and Other. We have recast certain previously reported amounts to conform to the way we internally manage and monitor segment performance.

Additional information on our reportable segments is contained in Note 19 – Segment Information and Geographic Data of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	Three Months Ended September 30,		Percentage Change
	2017	2016	
Revenue	$ 24,538	$ 21,928	12%
Gross margin	16,260	14,084	15%
Operating income	7,708	6,715	15%
Net income	6,576	5,667	16%
Diluted earnings per share	0.84	0.72	17%

Three Months Ended September 30, 2017 Compared with Three Months Ended September 30, 2016

Revenue increased $2.6 billion or 12%, driven by growth in Productivity and Business Processes and Intelligent Cloud. Productivity and Business Processes revenue increased, driven by the acquisition of LinkedIn and higher revenue from Office. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue was relatively unchanged, with lower revenue from phones offset by higher revenue from Search advertising and Surface.

Gross margin increased $2.2 billion or 15%, due to growth across each of our segments driven by higher revenue and LinkedIn. Gross margin percentage increased due to margin percentage increase in More Personal Computing and segment sales mix, offset in part by margin percentage decline in Intelligent Cloud. Gross margin percentage included an 8-point improvement in commercial cloud gross margin primarily across Azure and Office 365.

Operating income increased $993 million or 15%, primarily due to higher gross margin, offset in part by an increase in sales and marketing expenses and research and development expenses. Operating income included an operating loss of $294 million related to LinkedIn, including $372 million of amortization of intangible assets. Key changes in expenses were:

- Cost of revenue increased $434 million or 6%, mainly due to growth in our commercial cloud and LinkedIn, offset in part by a reduction in phone and Gaming cost of revenue.
- Sales and marketing expenses increased $594 million or 18%, primarily due to LinkedIn expenses.
- Research and development expenses increased $468 million or 15%, primarily due to LinkedIn expenses and investments in cloud engineering.
- General and administrative expenses increased $121 million or 12%, primarily due to LinkedIn expenses.

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SEGMENT RESULTS OF OPERATIONS

(In millions, except percentages)	Three Months Ended September 30, 2017	2016	Percentage Change
Revenue			
Productivity and Business Processes	$ 8,238	$ 6,436	28%
Intelligent Cloud	6,922	6,097	14%
More Personal Computing	9,378	9,395	0%
Total	$ 24,538	$ 21,928	12%
Operating Income			
Productivity and Business Processes	$ 3,006	$ 2,905	3%
Intelligent Cloud	2,137	1,777	20%
More Personal Computing	2,565	2,033	26%
Total	$ 7,708	$ 6,715	15%

Reportable Segments

Three Months Ended September 30, 2017 Compared with Three Months Ended September 30, 2016

Productivity and Business Processes

Revenue increased $1.8 billion or 28%, driven by LinkedIn and higher revenue from Office.

- LinkedIn contributed revenue of $1.1 billion, primarily comprised of revenue from Talent Solutions.
- Office Commercial revenue increased $516 million or 10%, driven by higher revenue from Office 365 commercial, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.
- Office Consumer revenue increased $96 million or 12%, driven by higher revenue from Office 365 consumer, mainly due to growth in subscribers.
- Dynamics revenue increased 13%, primarily due to higher revenue from Dynamics 365.

Operating income increased $101 million or 3%, primarily due to higher gross margin, offset in part by higher operating expenses.

- Gross margin increased $1.2 billion or 25%, primarily due to LinkedIn and growth in Office. Gross margin percentage decreased due to an increased mix of cloud offerings and LinkedIn, offset in part by gross margin percentage improvements in Office 365 commercial. Cost of revenue included $411 million related to LinkedIn, including $218 million of amortization of acquired intangible assets.
- Operating expenses increased $1.1 billion or 54%, driven by LinkedIn expenses of $1.0 billion, including $154 million of amortization of acquired intangible assets.

Intelligent Cloud

Revenue increased $825 million or 14%, primarily due to higher revenue from server products and cloud services.

- Server products and cloud services revenue increased $807 million or 17%, driven by Azure revenue growth of 90% and server products licensed on-premises revenue growth of 2%.
- Enterprise Services revenue increased 1%, driven by higher revenue from Premier Support Services, offset in part by a decline in revenue from custom support agreements.

Operating income increased $360 million or 20%, primarily due to higher gross margin, offset in part by higher operating expenses.

- Gross margin increased $434 million or 10%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies. Gross margin percentage decreased due to an

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increased mix of cloud offerings and lower Enterprise Services gross margin percentage, offset in part by improvement in Azure gross margin percentage.

- Operating expenses increased $74 million or 3%, driven by investments in commercial sales capacity and cloud engineering.

More Personal Computing

Revenue was relatively unchanged, with lower revenue from phones offset by higher revenue from Search advertising and Surface.

- Windows revenue was relatively unchanged, with growth in Windows OEM and Windows Commercial revenue offset by a decline in patent licensing revenue. Windows OEM revenue increased 4%. Windows OEM Pro revenue grew 7%, outperforming the commercial PC market, primarily due to a higher mix of premium licenses sold. Windows OEM non-Pro revenue declined 1%, in line with the consumer PC market. Windows Commercial revenue increased 7%, driven by multi-year agreement revenue growth.
- Search advertising revenue increased $210 million or 15%. Search advertising revenue, excluding traffic acquisition costs, increased 15%, primarily driven by growth in Bing, due to higher revenue per search and search volume.
- Surface revenue increased $113 million or 12%, driven by sales of the new Surface Laptop.
- Gaming revenue increased 1%, primarily due to higher revenue from Xbox software and services, offset in part by lower Xbox hardware revenue. Xbox software and services revenue increased 21%, driven by a higher volume of Xbox Live transactions, offset in part by a decline in revenue per transaction. Xbox hardware revenue decreased 48%, mainly due to a decline in volume of consoles sold and lower prices of consoles sold.
- Phone revenue decreased $315 million.

Operating income increased $532 million or 26%, primarily due to higher gross margin.

- Gross margin increased $494 million or 10%, driven by growth in Gaming, Search advertising, Surface, and Windows. Gross margin percentage increased due to gross margin percentage improvements across Gaming, Surface, Windows, and Search advertising and favorable sales mix.
- Operating expenses decreased slightly, driven by Windows and Gaming marketing expenses in the prior year and a reduction in phone expenses.

OPERATING EXPENSES

Research and Development

(In millions, except percentages)	Three Months Ended September 30, 2017	2016	Percentage Change
Research and development	$ 3,574	$ 3,106	15%
As a percent of revenue	15%	14%	1ppt

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 and services content.

Three Months Ended September 30, 2017 Compared with Three Months Ended September 30, 2016

Research and development expenses increased $468 million or 15%, primarily due to LinkedIn expenses and investments in cloud engineering. Expenses included $345 million related to LinkedIn.

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Sales and Marketing

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2017	2016	
Sales and marketing	$ 3,812	$ 3,218	18%
As a percent of revenue	16%	15%	1ppt

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 September 30, 2017 Compared with Three Months Ended September 30, 2016

Sales and marketing expenses increased $594 million or 18%, primarily due to LinkedIn expenses of $554 million, including $154 million of amortization of acquired intangible assets.

General and Administrative

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2017	2016	
General and administrative	$ 1,166	$ 1,045	12%
As a percent of revenue	5%	5%	0ppt

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 September 30, 2017 Compared with Three Months Ended September 30, 2016

General and administrative expenses increased $121 million or 12%, primarily due to LinkedIn expenses of $132 million.

OTHER INCOME (EXPENSE), NET

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

(In millions)

Three Months Ended September 30,	2017	2016
Dividends and interest income	$473	$293
Interest expense	(672)	(437)
Net recognized gains on investments	573	405
Net losses on derivatives	(50)	(94)
Net losses on foreign currency remeasurements	(9)	(40)
Other, net	(39)	(15)
Total	$276	$112

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), net. Other than those derivatives entered into for investment purposes, the gains (losses) are generally economically offset by unrealized (losses) gains in the underlying available-for-sale securities and (losses) gains on certain balance sheet amounts from foreign exchange rate changes.

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Three Months Ended September 30, 2017 Compared with Three Months Ended September 30, 2016

Dividends and interest income increased primarily due to higher portfolio balances and yields on fixed-income securities. Interest expense increased primarily due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities. Net losses on derivatives decreased due to gains on equity derivatives in the current period as compared to losses in the prior period and lower losses on commodity derivatives, offset in part by higher losses on foreign currency derivatives. Other, net reflects recognized losses from divestitures and certain joint ventures.

INCOME TAXES

Three Months Ended September 30, 2017 Compared with Three Months Ended September 30, 2016

Our effective tax rate for the three months ended September 30, 2017 and 2016 was 18% and 17%, 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 increase in our effective tax rate compared to the prior year was primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries.

Tax contingencies and other income tax liabilities were $13.9 billion and $13.5 billion as of September 30, 2017 and June 30, 2017, respectively, and are included in other long-term liabilities. This increase relates primarily to current period intercompany transfer pricing.

While we settled a portion of the Internal Revenue Service (“IRS”) audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and settled a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. We also continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of September 30, 2017, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

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 2017, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $138.5 billion and $133.0 billion as of September 30, 2017 and June 30, 2017, respectively. Equity and other investments were $5.3 billion and $6.0 billion as of September 30, 2017 and June 30, 2017, respectively. Our short-term investments are primarily intended 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 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.

Of the cash, cash equivalents, and short-term investments as of September 30, 2017, $132.1 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 $2.4 billion. As of September 30, 2017, approximately 88% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 3% were invested in U.S. mortgage- and asset-backed securities, and

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approximately 2% were invested in corporate notes and bonds of U.S. companies, all of which are denominated in U.S. dollars. The remaining cash equivalents and short-term investments held by our foreign subsidiaries were primarily invested in foreign securities.

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 consolidated balance sheets. 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 collateral received is recorded as an asset with a corresponding liability. Our securities lending payable balance was $203 million as of September 30, 2017. Our average and maximum securities lending payable balances for the three months ended September 30, 2017 were $4.8 billion and $5.6 billion, respectively. Intra-year 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 U.S. government securities, domestic and international equities, and exchange-traded mutual funds. 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 foreign government bonds, corporate notes and bonds, mortgage- and asset-backed securities, U.S. government and agency securities, certificates of deposit, and common and preferred stock. 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 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

Three Months Ended September 30, 2017 Compared with Three Months Ended September 30, 2016

Cash from operations increased $891 million to $12.4 billion for the three months ended September 30, 2017, mainly due to an increase in cash received from customers, offset in part by an increase in cash paid to employees, higher cash paid for interest on debt, and a reduction in unsettled cash equivalent investments in government securities. Cash used in financing was $6.3 billion for the three months ended September 30, 2017, compared to cash from financing of $14.3 billion for the three months ended September 30, 2016. The change was mainly due to a $22.3 billion decrease in proceeds from issuances of debt, net of repayments, and a $1.8 billion decrease in cash used for common stock repurchases, offset in part by a $203 million increase in dividends paid. Cash used in investing decreased $11.6 billion to $6.9 billion, mainly due to an $11.5 billion decrease in cash used for net investment purchases, sales, and maturities.

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. Refer to Note 11 – Debt of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

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Unearned Revenue

Unearned revenue is comprised mainly of unearned revenue related to volume licensing programs and includes Software Assurance ("SA") and cloud services. Unearned revenue is generally billed upfront at the beginning of each annual coverage period for multi-year agreements and recognized ratably over the coverage period. Unearned revenue also includes payments for other offerings for which we have been paid in advance and earn the revenue when we transfer control of the product or service. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

The following table outlines the expected future recognition of unearned revenue as of September 30, 2017:

(In millions)	
Three Months Ending,	
December 31, 2017	$10,330
March 31, 2018	7,007
June 30, 2018	4,310
September 30, 2018	1,131
Thereafter	2,126
Total	$24,904

If our customers choose 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.

Share Repurchases

For the three months ended September 30, 2017 and 2016, we repurchased 22 million shares and 63 million shares of our common stock for $1.6 billion and $3.6 billion, respectively, through our share repurchase programs. All repurchases were made using cash resources. Refer to Note 17 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Dividends

Refer to Note 17 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

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. Additionally, we have agreed to cover damages resulting from breaches of certain security and privacy commitments in our cloud business. 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 consolidated financial statements during the periods presented.

Other Planned Uses of Capital

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology, as well as continue making acquisitions that align with our business strategy. 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 to support growth in our cloud offerings. We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, 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.

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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, cash flows from operations, and access to capital markets 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 maturities, 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 in the U.S. 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 domestically and continue to believe we have the ability to do so at reasonable interest rates.

RECENT ACCOUNTING GUIDANCE

Refer to Note 1 – Accounting Policies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing consolidated 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

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. Judgment is required to determine the level of integration and interdependency between individual components of cloud services. This determination influences whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time.

Judgment is required to determine the stand-alone selling price ("SSP") for each distinct performance obligation. We use a single amount to estimate SSP for items that are not sold separately, including on-premises licenses sold with SA, or software updates provided at no additional charge. We use a range of amounts to estimate SSP when we sell each of the products and services separately and need to determine whether there is a discount that needs to be allocated based on the relative SSP of the various products and services.

In instances where SSP is not directly observable, such as when we do not sell the product or service separately, we determine the SSP using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual products and services due to the stratification of those products and services by customers and circumstances. In these instances, we may use information such as the size of the customer and geographic region in determining the SSP.

Due to the various benefits from and the nature of our SA program, judgment is required to assess the pattern of delivery, including the exercise pattern of certain benefits across our portfolio of customers.

Our products are generally sold with a right of return and we may provide other credits or incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize.

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The new standard related to revenue recognition had a material impact on our consolidated financial statements. Refer to Note 1 – Accounting Policies in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Impairment of Investment Securities

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

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Income Taxes

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign exchange rates, interest rates, credit risk, and equity prices. A portion of these risks is hedged, but they may impact our consolidated 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, Canadian dollar, and Australian 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 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.

VALUE-AT-RISK

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 of America (“U.S. GAAP”), 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 exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

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:

(In millions)

Risk Categories	September 30, 2017	June 30, 2017	Three Months Ended September 30, 2017 Average	High	Low
Foreign currency	$ 233	$114	$ 155	$ 240	$ 79
Interest rate	154	152	147	154	142
Equity	36	54	45	55	36

Total one-day VaR for the combined risk categories was $296 million and $207 million as of September 30, 2017 and June 30, 2017, respectively. The total VaR is 30% and 35% less as of September 30, 2017 and June 30, 2017, respectively, than the sum of the separate risk categories in the table above due to the diversification benefit of the combination of risks.

PART I

Item 4

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 September 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We implemented internal controls to ensure we adequately evaluated our contracts and properly assessed the impact of the new accounting standards related to revenue recognition and leases on our financial statements to facilitate their adoption on July 1, 2017. There were no significant changes to our internal control over financial reporting due to the adoption of the new standards.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Refer to Note 16 – 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

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 many of our businesses are low and 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.

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. 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 succeeded with some consumer products such as personal computers, tablets, phones, gaming consoles, and wearables. Competitors pursuing this model also earn revenue from services integrated with the hardware and software platform. We also offer some vertically-integrated hardware and software products and services. To the extent we shift a portion of our business to a vertically integrated model we 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 significant competition 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 were 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 application developers to our PC operating system

platforms. Competing with operating systems licensed at low or no cost may decrease our PC operating system margins. In addition, some of our devices compete with products made by our original equipment manufacturer ("OEM") partners, which may affect their commitment to our platform.

- Competing platforms have content and application marketplaces with scale and significant installed bases. The variety and utility of content and applications available on a platform are important to device purchasing decisions. Users sometimes incur costs to move data and buy new content and applications when switching platforms. 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 competitors' content and application marketplaces may increase our cost of revenue and lower our operating margins.

PART II

Item 1A

Business model competition

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

- Even as we transition more of our business to a services and subscription business model, the license-based proprietary software model generates most of our software 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.
- 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.
- 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 cause decreased sales volumes, price reductions, and/or increased operating costs, such as for research and development, marketing, and sales incentives. This may lead to lower revenue, gross margins, and operating income.

Our increasing focus on services presents execution and competitive risks. A growing part of our business involves cloud-based services available across the spectrum of computing devices. Our strategic vision is to compete and grow by building best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence. At the same time, 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 sometimes the user's choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our cloud-based strategies. The Windows ecosystem must continue to evolve with this changing environment. We are undertaking cultural and organizational changes to drive accountability and eliminate obstacles to innovation. The Company's investment in gaining insights from data is becoming central to the value of the services we deliver to customers, to our operational efficiency and key opportunities in monetization, customer perceptions of quality, and operational efficiency. Our ability to use data in this way may be constrained by regulatory developments that impede realizing the expected return from this investment.

Besides software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs will reduce the operating margins we have previously achieved. Whether we succeed in cloud-based services depends on our execution in several 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, gaming consoles, and other television-related devices.
- Continuing to enhance the attractiveness of our cloud platforms to third-party developers.
- Ensuring our cloud-based services meet the reliability expectations of our customers and maintain the security of their data.
- Making our suite of cloud-based services platform-agnostic, available on a wide range of devices and ecosystems, including those of our competitors.

It is uncertain whether our strategies will attract the users or generate the revenue required to succeed. If we are not effective in executing organizational and technical changes to increase efficiency and accelerate innovation, or if we fail to generate sufficient usage of our new products and services, we may not grow revenue in line with the infrastructure and development investments described above. This may negatively impact gross margins and operating income.

PART II

Item 1A

We make significant investments in new products and services that may not achieve expected returns. We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows operating system, Microsoft Office, Bing, SQL Server, Windows Server, the Windows Store, Microsoft Azure, Office 365, other cloud-based offerings, Xbox Live, and LinkedIn. We also invest in the development and acquisition of a variety of hardware for productivity, communication, and entertainment including PCs, tablets, gaming devices, and HoloLens. 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 and hardware products or upgrades, unfavorably affecting revenue. We may not achieve significant revenue from new product, service, and distribution channel investments for several years, if at all. 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.

We did extensive preparation and ongoing compatibility testing for applications and devices to help ensure a positive experience for our users installing Windows 10. However, negative upgrade experiences could adversely affect the reception of Windows 10 in the marketplace and could lead to litigation or regulatory actions by customers and government agencies. In addition, we anticipate that Windows 10 will enable new post-license monetization opportunities beyond initial license revenues. Our inability to realize these opportunities to the extent we expect could have an adverse impact on our revenues. Finally, our practices for data collection, use, and management in Windows 10 are subject to regulatory review, and may result in decisions directing us to change these practices and imposing fines. If so, we could face negative public reaction, degraded user experiences, and reduced flexibility in product design.

Developing new technologies is complex. It can require long development and testing periods. Significant delays in new releases or significant problems in creating new products or services could adversely affect our revenue.

Acquisitions, joint ventures, and strategic alliances may have an adverse effect on our business. We expect to continue making acquisitions and entering into joint ventures and strategic alliances as part of our long-term business strategy. In December 2016, we completed our acquisition of LinkedIn for $27.0 billion. The LinkedIn acquisition and other transactions and arrangements involve significant challenges and risks, including that they do not advance our business strategy, that we get an unsatisfactory return on our investment, that we have difficulty integrating and retaining new employees, business systems, and technology, or that they distract management from our other businesses. If an arrangement fails to adequately anticipate changing circumstances and interests of a party, it may result in early termination or renegotiation of the arrangement. The success of these transactions and arrangements will depend in part on our ability to leverage them to enhance our existing products and services or develop compelling new ones. It may take longer than expected to realize the full benefits from these transactions and arrangements, 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.

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 cause an impairment of goodwill or intangibles. 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 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 industry segments in which we participate. We may be required to record a significant charge on our consolidated financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively affecting our results of operations. For example, in the fourth quarter of fiscal year 2015, we recorded a $5.1 billion charge for the impairment of goodwill and a $2.2 billion charge for the impairment of intangible assets, and in the fourth quarter of fiscal year 2016 we recorded a $480 million charge for the impairment of intangible assets. The impairment charges for both periods related to our phone business. Our acquisition of LinkedIn resulted in a significant increase in our goodwill and intangible asset balances.

PART II

Item 1A

We may not earn the revenues we expect from our intellectual property rights.

We may not be able to adequately protect our intellectual property rights

Protecting our intellectual property rights and combating unlicensed copying and use of our software and other intellectual property on a global basis 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. Our revenue in these markets may grow slower than the underlying device market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we educate users 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. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

We may not receive expected royalties from our patent licenses

We expend significant resources to patent the intellectual property we create with the expectation that we will generate revenues by incorporating that intellectual property in our products or services or, in some instances, by licensing our patents to others in return for a royalty. Changes in the law may weaken our ability to prevent the use of patented technology or collect revenue for licensing our patents. These include legislative changes and regulatory actions that make it more difficult to obtain injunctions, and the increasing use of legal process to challenge issued patents. Similarly, licensees of our patents may fail to satisfy their obligations to pay us royalties, or may contest the scope and extent of their obligations. Finally, the royalties we can obtain to monetize our intellectual property may decline because of the evolution of technology, selling price changes in products using licensed patents, or the difficulty of discovering infringements.

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 first-party 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. Besides 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