MICROSOFT CORP
Form 10-Q
January 24, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended December 31, 2007

OR

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

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

Washington **(State or other jurisdiction of** **incorporation or organization)**	**91-1144442** **(I.R.S. Employer** **Identification No.)**
One Microsoft Way, Redmond, Washington **(Address of principal executive offices)**	**98052-6399** **(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 x No ¨

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

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

Class	**Outstanding at January 21, 2008**
Common Stock, $0.00000625 par value per share	9,306,979,746 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2007

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

INCOME STATEMENTS

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Revenue	**$ 16,367**	$ 12,542	**$ 30,129**	$ 23,353
Operating expenses:				
Cost of revenue	**3,543**	3,620	**6,218**	5,316
Research and development	**1,885**	1,637	**3,722**	3,423
Sales and marketing	**3,392**	2,999	**6,006**	5,190
General and administrative	**1,066**	814	**1,784**	1,478
Total operating expenses	**9,886**	9,070	**17,730**	15,407
Operating income	**6,481**	3,472	**12,399**	7,946
Investment income and other	**339**	333	**637**	900
Income before income taxes	**6,820**	3,805	**13,036**	8,846
Provision for income taxes	**2,113**	1,179	**4,040**	2,742
Net income	**$ 4,707**	$ 2,626	**$ 8,996**	$ 6,104
Earnings per share:				
Basic	**$ 0.50**	$ 0.27	**$ 0.96**	$ 0.62
Diluted	**$ 0.50**	$ 0.26	**$ 0.95**	$ 0.61
Weighted average shares outstanding:				
Basic	**9,361**	9,806	**9,370**	9,867
Diluted	**9,503**	9,942	**9,519**	9,996
Cash dividends declared per common share	**$ 0.11**	$ 0.10	**$ 0.22**	$ 0.20

See accompanying notes.

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MICROSOFT CORPORATION

BALANCE SHEETS

(In millions)

	December 31, 2007 (Unaudited)	June 30, 2007(1)
Assets		
Current assets:		
Cash and cash equivalents	**$ 7,460**	$ 6,111
Short-term investments (including securities pledged as collateral of $1,984 and $2,356)	**13,616**	17,300
Total cash, cash equivalents, and short-term investments	**21,076**	23,411
Accounts receivable, net of allowance for doubtful accounts of $149 and $117	**11,621**	11,338
Inventories, net	**755**	1,127
Deferred income taxes	**1,483**	1,899
Other	**2,840**	2,393
Total current assets	**37,775**	40,168
Property and equipment, net	**4,965**	4,350
Equity and other investments	**9,413**	10,117
Goodwill	**10,309**	4,760
Intangible assets, net	**1,717**	878
Deferred income taxes	**1,200**	1,389
Other long-term assets	**1,960**	1,509
Total assets	**$ 67,339**	$ 63,171
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,612**	$ 3,247
Accrued compensation	**1,977**	2,325
Income taxes	**863**	1,040
Short-term unearned revenue	**10,221**	10,779
Securities lending payable	**2,166**	2,741
Other	**3,219**	3,622
Total current liabilities	**22,058**	23,754
Long-term unearned revenue	**1,957**	1,867
Other long-term liabilities	**8,893**	6,453
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding 9,329 and 9,380	**62,528**	60,557
Retained deficit, including accumulated other comprehensive income of $1,628 and $1,654	**(28,097)**	(29,460)
Total stockholders equity	**34,431**	31,097
Total liabilities and stockholders equity	**$ 67,339**	$ 63,171

(1) Derived from audited financial statements.

See accompanying notes.

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MICROSOFT CORPORATION

CASH FLOWS STATEMENTS

(In millions)(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Operations				
Net income	**$ 4,707**	$ 2,626	**$ 8,996**	$ 6,104
Depreciation, amortization, and other noncash items	**481**	365	**916**	614
Stock-based compensation expense	**360**	437	**693**	893
Net recognized gains on investments	**(134)**	(29)	**(321)**	(235)
Excess tax benefits from stock-based payment arrangements	**(33)**	(8)	**(102)**	(48)
Deferred income taxes	**323**	(517)	**680**	(351)
Unearned revenue	**5,995**	6,029	**9,816**	9,246
Recognition of unearned revenue	**(5,368)**	(4,265)	**(10,333)**	(8,315)
Accounts receivable	**(2,586)**	(2,945)	**220**	(444)
Other current assets	**445**	723	**210**	(357)
Other long-term assets	**(55)**	(264)	**(66)**	(399)
Other current liabilities	**325**	(354)	**(864)**	(1,196)
Other long-term liabilities	**107**	244	**600**	591
Net cash from operations	**4,567**	2,042	**10,445**	6,103
Financing				
Common stock issued	**2,335**	4,449	**2,981**	4,834
Common stock repurchased	**(4,057)**	(5,797)	**(6,987)**	(13,480)
Common stock cash dividends	**(1,034)**	(980)	**(1,972)**	(1,877)
Excess tax benefits from stock-based payment arrangements	**33**	8	**102**	48
Other		(3)		(23)
Net cash used in financing	**(2,723)**	(2,323)	**(5,876)**	(10,498)
Investing				
Additions to property and equipment	**(695)**	(572)	**(1,205)**	(983)
Acquisition of companies, net of cash acquired	**(433)**	(125)	**(5,829)**	(461)
Purchases of investments	**(6,317)**	(9,102)	**(12,314)**	(21,957)
Maturities of investments	**470**	1,325	**800**	2,159
Sales of investments	**6,696**	7,448	**15,816**	26,149
Securities lending payable	**(770)**	(932)	**(574)**	(404)
Net cash from/(used in) investing	**(1,049)**	(1,958)	**(3,306)**	4,503
Effect of exchange rates on cash and cash equivalents	**28**	22	**86**	37
Net change in cash and cash equivalents	**823**	(2,217)	**1,349**	145
Cash and cash equivalents, beginning of period	**6,637**	9,076	**6,111**	6,714
Cash and cash equivalents, end of period	**$ 7,460**	$ 6,859	**$ 7,460**	$ 6,859

See accompanying notes.

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MICROSOFT CORPORATION

STOCKHOLDERS EQUITY STATEMENTS

(In millions)(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Common stock and paid-in capital				
Balance, beginning of period	**$ 60,699**	$ 57,657	**$ 60,557**	$ 59,005
Common stock issued	**2,380**	4,436	**3,035**	4,834
Common stock repurchased	**(805)**	(1,232)	**(1,621)**	(3,106)
Stock-based compensation expense	**360**	437	**693**	893
Stock option income tax deficiencies	**(106)**	(147)	**(193)**	(481)
Other, net		1	**57**	7
Balance, end of period	**62,528**	61,152	**62,528**	61,152
Retained deficit				
Balance, beginning of period	**(28,564)**	(21,556)	**(29,460)**	(18,901)
Cumulative effect of a change in accounting principle adoption of FIN 48 (1)			**(395)**	
Cumulative effect of a change in accounting principle adoption of EITF 06-2 (1)			**(17)**	
Net income	**4,707**	2,626	**8,996**	6,104
Other comprehensive income:				
Net gains/(losses) on derivative instruments	**137**	(1)	**49**	(28)
Net unrealized investments gains/(losses)	**(78)**	184	**(164)**	337
Translation adjustments and other	**39**	35	**89**	44
Comprehensive income	**4,805**	2,844	**8,970**	6,457
Common stock cash dividends	**(1,031)**	(974)	**(2,060)**	(1,949)
Common stock repurchased	**(3,307)**	(4,832)	**(5,135)**	(10,125)
Balance, end of period	**(28,097)**	(24,518)	**(28,097)**	(24,518)
Total stockholders equity	**$ 34,431**	$ 36,634	**$ 34,431**	$ 36,634

(1) See Note 1 of Notes to Financial Statements.

See accompanying notes.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

Note 1 Basis of Presentation and Consolidation and Recent Accounting Pronouncements

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include: estimates of loss contingencies, product warranties, product life cycles, product returns, and stock-based compensation forfeiture rates; assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our financial statements or tax returns; estimating the fair value and/or goodwill impairment for our reporting units; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management s estimates and assumptions.

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 2007 Form 10-K.

Basis of Consolidation

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

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141 (revised 2007), *Business Combinations*, which replaces SFAS No 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for us beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51*, which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for us beginning July 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. We are currently assessing the potential impact that adoption of SFAS No. 160 would have on our financial statements.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

On July 1, 2007, we adopted the provisions of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109,* which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, we may 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 should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Upon adoption, we recognized a $395 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle. See Note 13 Income Taxes.

On July 1, 2007, we adopted Emerging Issues Task Force Issue No. 06-2 (EITF 06-2), *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43*. EITF 06-2 requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. Upon adoption, we recognized a $17 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings. SFAS No. 159 is effective for us beginning July 1, 2008, although early adoption is permitted. We are currently assessing the potential impact that electing fair value measurement would have on our financial statements and have not determined what election we will make.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for us beginning July 1, 2008. In December 2007, the FASB released a proposed FASB Staff Position (FSP FAS 157-b *Effective Date of FASB Statement No. 157*) which, if adopted as proposed, would delay the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We are currently assessing the potential impact that adoption of this statement would have on our financial statements.

Note 2 Inventories

Components of inventories were as follows:

(In millions)	December 31, 2007	June 30, 2007
Raw materials	**$ 241**	$ 435
Work in process	**77**	148
Finished goods	**437**	544
Inventories	**$ 755**	$ 1,127

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3 Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of 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, stock awards, and shared performance stock awards.

Components of basic and diluted earnings per share were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
(In millions, except earnings per share)	**2007**	**2006**	**2007**	**2006**
Net income available for common shareholders (A)	**$ 4,707**	$ 2,626	**$ 8,996**	$ 6,104
Weighted average outstanding shares of common stock (B)	**9,361**	9,806	**9,370**	9,867
Dilutive effect of employee stock options and awards	**142**	136	**149**	129
Common stock and common stock equivalents (C)	**9,503**	9,942	**9,519**	9,996
Earnings per share:				
Basic (A/B)	**$ 0.50**	$ 0.27	**$ 0.96**	$ 0.62
Diluted (A/C)	**$ 0.50**	$ 0.26	**$ 0.95**	$ 0.61

The following shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. In addition, the following shared performance stock awards have been excluded from the calculation of diluted earnings per share because the number of shares ultimately issued is contingent on our performance against metrics established for the performance period.

	Three Months Ended December 31,		Six Months Ended December 31,	
(In millions)	**2007**	**2006**	**2007**	**2006**
Shares excluded from calculation of diluted EPS	**71**	240	**77**	266
Shared performance stock awards excluded from calculation of diluted EPS		10		10

Note 4 Unearned Revenue

The components of unearned revenue were as follows:

(In millions)	**December 31, 2007**	**June 30, 2007**

Volume licensing programs	**$ 9,145**	$ 9,334
Undelivered elements	**1,650**	1,839
Other	**1,383**	1,473
Unearned revenue	**$ 12,178**	$ 12,646

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Unearned revenue by segment was as follows:

(In millions)	December 31, 2007	June 30, 2007
Client	**$ 2,620**	$ 2,875
Server and Tools	**3,746**	3,652
Microsoft Business Division	**5,359**	5,771
Other	**453**	348
Unearned revenue	**$ 12,178**	$ 12,646

Note 5 Stockholders Equity

Share Repurchases

On July 20, 2006, we announced that our Board of Directors authorized two new share repurchase programs: a $20.0 billion tender offer that was completed on August 17, 2006 and authorization for up to an additional $20.0 billion ongoing share repurchase program with an expiration of June 30, 2011. Under the tender offer, we repurchased approximately 155 million shares of common stock, or 1.5% of our common shares outstanding, for approximately $3.8 billion at a price per share of $24.75. On August 18, 2006, we announced that the authorization for the $20.0 billion ongoing share repurchase program had been increased by approximately $16.2 billion. As a result, we are authorized to repurchase additional shares in an amount up to $36.2 billion through June 30, 2011. As of December 31, 2007, approximately $8.7 billion remained of the $36.2 billion approved repurchase amount. All repurchases were made using cash resources. The repurchase program may be suspended or discontinued at any time without notice.

We repurchased the following shares of common stock under the above-described repurchase plans:

	Three Months Ended December 31,		Six Months Ended December 31,	
(In millions)	2007	2006	2007	2006
Shares of common stock repurchased	**120**	205	**200**	491
Value of common stock repurchased	**$ 4,081**	$ 6,037	**$ 6,429**	$ 12,989

Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
(Fiscal year 2008)				
September 12, 2007	$ 0.11	November 15, 2007	$ 1,034	December 13, 2007
December 19, 2007	$ 0.11	February 21, 2008	$ 1,026(1)	March 13, 2008

(Fiscal year 2007)						
September 13, 2006	$	0.10	November 16, 2006	$	979	December 14, 2006
December 20, 2006	$	0.10	February 15, 2007	$	977	March 8, 2007

(1) This dividend was included in other current liabilities on our balance sheet as of December 31, 2007.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6 Investment Income and Other

Components of investment income and other were as follows:

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
(In millions)	2007	2006	2007	2006
Dividends and interest	**$ 206**	$ 316	**$ 445**	$ 685
Net recognized gains on investments	**87**	103	**238**	466
Net gains/(losses) on derivatives	**48**	(75)	**84**	(231)
Other	**(2)**	(11)	**(130)**	(20)
Investment income and other	**$ 339**	$ 333	**$ 637**	$ 900

Note 7 Product Warranties

We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include technical support, parts, and labor over a period generally ranging from 90 days to three years. For software warranty, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software.

The changes in our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities on our balance sheets, were as follows:

(In millions)	Amount
Balance at July 1, 2007	$ 850
Accruals for warranties issued	82
Adjustments to pre-existing warranties	11
Settlements of warranty claims	(86)
Balance at September 30, 2007	$ 857
Accruals for warranties issued	**188**
Adjustments to pre-existing warranties	**5**
Settlements of warranty claims	**(189)**
Balance at December 31, 2007	**$ 861**

Note 8 Contingencies

Government competition law matters. In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were not reasonable. Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should be imposed as from that date. The maximum amount of the potential fine for violation of the March 2004 decision as of October 22, 2007 was 1.5 billion. On January 14, 2008, the European Commission announced that it was