MICROSOFT CORP
Form 10-Q
January 28, 2016
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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, 2015

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	**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 x No ¨

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

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

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

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

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

Class	Outstanding at January 22, 2016
Common Stock, $0.00000625 par value per share	7,909,302,774 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2015

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Revenue	**$ 23,796**	$ 26,470	**$ 44,175**	$ 49,671
Cost of revenue	**9,872**	10,136	**17,079**	18,409
Gross margin	**13,924**	16,334	**27,096**	31,262
Research and development	**2,900**	2,903	**5,862**	5,968
Sales and marketing	**3,960**	4,315	**7,293**	8,043
General and administrative	**1,038**	1,097	**2,122**	2,248
Impairment, integration, and restructuring	**0**	243	**0**	1,383
Operating income	**6,026**	7,776	**11,819**	13,620
Other income (expense), net	**(171)**	74	**(451)**	126
Income before income taxes	**5,855**	7,850	**11,368**	13,746
Provision for income taxes	**857**	1,987	**1,750**	3,343
Net income	**$ 4,998**	$ 5,863	**$ 9,618**	$ 10,403
Earnings per share:				
Basic	**$ 0.63**	$ 0.71	**$ 1.21**	$ 1.26
Diluted	**$ 0.62**	$ 0.71	**$ 1.20**	$ 1.25
Weighted average shares outstanding:				
Basic	**7,964**	8,228	**7,980**	8,238
Diluted	**8,028**	8,297	**8,047**	8,321
Cash dividends declared per common share	**$ 0.36**	$ 0.31	**$ 0.72**	$ 0.62

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Net income	**$ 4,998**	$ 5,863	**$ 9,618**	$ 10,403
Other comprehensive income (loss):				
Net unrealized gains (losses) on derivatives (net of tax effects of **$5**, $6, **$28**, and $10)	**(49)**	247	**8**	566
Net unrealized gains (losses) on investments (net of tax effects of **$86**, $(124), **$(222)**, and $(226))	**160**	(231)	**(411)**	(420)
Translation adjustments and other (net of tax effects of **$(9)**, $(211), **$(21)**, and $(258))	**(76)**	(390)	**(346)**	(471)
Other comprehensive income (loss)	**35**	(374)	**(749)**	(325)
Comprehensive income	**$ 5,033**	$ 5,489	**$ 8,869**	$ 10,078

See accompanying notes.

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BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2015	June 30, 2015
Assets		
Current assets:		
Cash and cash equivalents	**$ 7,185**	$ 5,595
Short-term investments (including securities loaned of **$360** and $75)	**95,455**	90,931
Total cash, cash equivalents, and short-term investments	**102,640**	96,526
Accounts receivable, net of allowance for doubtful accounts of **$384** and $335	**14,507**	17,908
Inventories	**2,702**	2,902
Deferred income taxes	**1,618**	1,915
Other	**6,345**	5,461
Total current assets	**127,812**	124,712
Property and equipment, net of accumulated depreciation of **$18,008** and $17,606	**15,789**	14,731
Equity and other investments	**11,514**	12,053
Goodwill	**17,436**	16,939
Intangible assets, net	**4,619**	4,835
Other long-term assets	**2,928**	2,953
Total assets	**$ 180,098**	$ 176,223
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 6,936**	$ 6,591
Short-term debt	**3,000**	4,985
Current portion of long-term debt	**750**	2,499
Accrued compensation	**3,649**	5,096
Income taxes	**493**	606
Short-term unearned revenue	**20,929**	23,223
Securities lending payable	**439**	92
Other	**6,447**	6,766
Total current liabilities	**42,643**	49,858
Long-term debt	**40,679**	27,808
Long-term unearned revenue	**4,102**	2,095
Deferred income taxes	**2,194**	2,835
Other long-term liabilities	**13,700**	13,544
Total liabilities	**103,318**	96,140

Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **7,925** and 8,027	**68,279**	68,465
Retained earnings	**6,728**	9,096
Accumulated other comprehensive income	**1,773**	2,522
Total stockholders equity	**76,780**	80,083
Total liabilities and stockholders equity	**$ 180,098**	$ 176,223

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Operations				
Net income	**$ 4,998**	$ 5,863	**$ 9,618**	$ 10,403
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	**1,544**	1,521	**3,005**	2,949
Stock-based compensation expense	**658**	633	**1,332**	1,279
Net recognized losses (gains) on investments and derivatives	**50**	(179)	**151**	(124)
Excess tax benefits from stock-based compensation	**(20)**	(22)	**(302)**	(524)
Deferred income taxes	**(247)**	314	**(174)**	615
Deferral of unearned revenue	**12,570**	10,200	**22,993**	18,222
Recognition of unearned revenue	**(11,929)**	(11,495)	**(23,284)**	(22,138)
Changes in operating assets and liabilities:				
Accounts receivable	**(3,118)**	(3,378)	**3,258**	3,249
Inventories	**1,104**	1,070	**167**	587
Other current assets	**(912)**	(159)	**(1,192)**	(439)
Other long-term assets	**56**	170	**51**	449
Accounts payable	**369**	137	**234**	(522)
Other current liabilities	**105**	(986)	**(1,919)**	(2,152)
Other long-term liabilities	**370**	651	**254**	840
Net cash from operations	**5,598**	4,340	**14,192**	12,694
Financing				
Proceeds from issuance (repayments) of short-term debt, maturities of 90 days or less, net	**(7,031)**	4,798	**(2,141)**	7,797
Proceeds from issuance of debt	**13,128**	0	**13,249**	0
Repayments of debt	**(121)**	0	**(1,871)**	(1,500)
Common stock issued	**117**	121	**336**	337
Common stock repurchased	**(3,678)**	(2,145)	**(8,435)**	(5,033)
Common stock cash dividends paid	**(2,868)**	(2,547)	**(5,343)**	(4,854)
Excess tax benefits from stock-based compensation	**20**	22	**302**	524
Other	**(65)**	285	**(243)**	285
Net cash from (used in) financing	**(498)**	534	**(4,146)**	(2,444)
Investing				
Additions to property and equipment	**(2,024)**	(1,490)	**(3,380)**	(2,772)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(381)**	(2,794)	**(771)**	(2,935)
Purchases of investments	**(34,750)**	(19,167)	**(72,320)**	(43,252)
Maturities of investments	**5,351**	2,389	**11,037**	4,082

Sales of investments	**28,191**	16,108	**56,693**	32,553
Securities lending payable	**285**	238	**347**	(129)
Net cash used in investing	**(3,328)**	(4,716)	**(8,394)**	(12,453)
Effect of foreign exchange rates on cash and cash equivalents	**(18)**	(34)	**(62)**	(40)
Net change in cash and cash equivalents	**1,754**	124	**1,590**	(2,243)
Cash and cash equivalents, beginning of period	**5,431**	6,302	**5,595**	8,669
Cash and cash equivalents, end of period	**$ 7,185**	$ 6,426	**$ 7,185**	$ 6,426

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Common stock and paid-in capital				
Balance, beginning of period	**$ 68,093**	$ 68,362	**$ 68,465**	$ 68,366
Common stock issued	**117**	121	**336**	337
Common stock repurchased	**(609)**	(376)	**(2,157)**	(1,744)
Stock-based compensation expense	**658**	633	**1,332**	1,279
Stock-based compensation income tax benefits	**20**	23	**302**	525
Other, net	**0**	2	**1**	2
Balance, end of period	**68,279**	68,765	**68,279**	68,765
Retained earnings				
Balance, beginning of period	**7,614**	18,051	**9,096**	17,710
Net income	**4,998**	5,863	**9,618**	10,403
Common stock cash dividends	**(2,846)**	(2,534)	**(5,708)**	(5,093)
Common stock repurchased	**(3,038)**	(1,649)	**(6,278)**	(3,289)
Balance, end of period	**6,728**	19,731	**6,728**	19,731
Accumulated other comprehensive income				
Balance, beginning of period	**1,738**	3,757	**2,522**	3,708
Other comprehensive income (loss)	**35**	(374)	**(749)**	(325)
Balance, end of period	**1,773**	3,383	**1,773**	3,383
Total stockholders equity	**$ 76,780**	$ 91,879	**$ 76,780**	$ 91,879

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Accounting Principles

We prepare our unaudited interim consolidated financial statements in conformity 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 2015 Form 10-K and Form 8-K filed with the U.S. Securities and Exchange Commission on July 31, 2015 and October 27, 2015, respectively.

We have recast certain prior period amounts to conform to the current period presentation, with no impact on consolidated net income or cash flows.

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 through which we are able to exercise significant influence over but do not control the investee and are not the primary beneficiary of the investee s activities are accounted for using the equity method. Investments through which we are not able to exercise significant influence over the investee and which do not have readily determinable fair values are accounted for under the cost method.

Recasting of Certain Prior Period Information

In June 2015, we announced a change in organizational structure as part of our transformation in the mobile-first, cloud-first world. During the first quarter of fiscal year 2016, the Company s chief operating decision maker, who is also our Chief Executive Officer, requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. As a result, beginning in fiscal year 2016, we report our financial performance based on our new segments described in Note 18 Segment Information. We have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance during fiscal year 2016. This change primarily impacted Note 9 Goodwill, Note 14 Unearned Revenue, and Note 18 Segment Information, with no impact on consolidated net income or cash flows.

Estimates and Assumptions

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples of estimates include: loss contingencies; product warranties; the fair value of, and/or potential impairment of goodwill and intangibles assets, for our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; allowances for product returns; the market value of our inventory; and stock-based compensation forfeiture rates. Examples of assumptions include: the elements comprising a software arrangement, including the distinction between upgrades or enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our 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 Recognition for Windows 10 Licenses

Customers purchasing a Windows 10 license will receive unspecified updates and upgrades over the life of their Windows 10 device at no additional cost. As these updates and upgrades will not be sold on a stand-alone basis, we are unable to establish vendor-specific objective evidence of fair value. Accordingly, revenue from licenses of Windows 10 is recognized ratably over the estimated life of the related device, which ranges between two to four years.

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Recent Accounting Guidance Not Yet Adopted

In May 2014, the Financial Accounting Standards Board (FASB) issued a new standard related to revenue recognition. Under the new standard, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration which 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. The new standard will be effective for us beginning July 1, 2018, and adoption as of the original effective date of July 1, 2017 is permitted. We anticipate this standard will have a material impact on our consolidated financial statements, and we are currently evaluating its impact.

In January 2016, the FASB issued a new standard to amend certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the amendments 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 new standard will be effective for us beginning July 1, 2018. The application of the amendments will result in a cumulative-effect adjustment to our consolidated balance sheet as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements.

NOTE 2 EARNINGS PER SHARE

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

The components of basic and diluted EPS are as follows:

	Three Months Ended		**Six Months Ended**	
(In millions, except earnings per share)	**December 31,**		**December 31,**	
	2015	**2014**	**2015**	**2014**
Net income available for common shareholders (A)	**$ 4,998**	$ 5,863	**$ 9,618**	$ 10,403
Weighted average outstanding shares of common stock (B)	**7,964**	8,228	**7,980**	8,238
Dilutive effect of stock-based awards	**64**	69	**67**	83
Common stock and common stock equivalents (C)	**8,028**	8,297	**8,047**	8,321
Earnings Per Share				
Basic (A/B)	**$ 0.63**	$ 0.71	**$ 1.21**	$ 1.26
Diluted (A/C)	**$ 0.62**	$ 0.71	**$ 1.20**	$ 1.25

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 December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Dividends and interest income	$ 200	$ 183	$ 399	$ 408
Interest expense	(309)	(162)	(558)	(323)
Net recognized gains on investments	106	317	108	396
Net losses on derivatives	(156)	(138)	(259)	(272)
Net gains (losses) on foreign currency remeasurements	2	83	(34)	161
Other	(14)	(209)	(107)	(244)
Total	$ (171)	$ 74	$ (451)	$ 126

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Other-than-temporary impairments of investments	$ (127)	$ (26)	$ (162)	$ (35)
Realized gains from sales of available-for-sale securities	351	421	458	539
Realized losses from sales of available-for-sale securities	(118)	(78)	(188)	(108)
Total	$ 106	$ 317	$ 108	$ 396

NOTE 4 INVESTMENTS

Investment Components

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

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash	Short-term Investments	Equity and Other

				Equivalents		Investments
December 31, 2015						
Cash	**$ 3,480**	**$ 0**	**$ 0**	**$ 3,480**	**$ 3,480**	**$ 0**	**$ 0**
Mutual funds	**1,428**	**0**	**0**	**1,428**	**1,428**	**0**	**0**
Commercial paper	**790**	**0**	**0**	**790**	**790**	**0**	**0**
Certificates of deposit	**1,062**	**0**	**0**	**1,062**	**921**	**141**	**0**
U.S. government and agency securities	**79,113**	**11**	**(232)**	**78,892**	**350**	**78,542**	**0**
Foreign government bonds	**4,973**	**3**	**(39)**	**4,937**	**216**	**4,721**	**0**
Mortgage- and asset-backed securities	**4,849**	**17**	**(9)**	**4,857**	**0**	**4,857**	**0**
Corporate notes and bonds	**6,914**	**65**	**(106)**	**6,873**	**0**	**6,873**	**0**
Municipal securities	**285**	**36**	**0**	**321**	**0**	**321**	**0**
Common and preferred stock	**6,395**	**4,862**	**(333)**	**10,924**	**0**	**0**	**10,924**
Other investments	**565**	**0**	**0**	**565**	**0**	**0**	**565**
Total	**$ 109,854**	**$ 4,994**	**$ (719)**	**$ 114,129**	**$ 7,185**	**$ 95,455**	**$ 11,489**

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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, 2015							
Cash	$ 3,679	$ 0	$ 0	$ 3,679	$ 3,679	$ 0	$ 0
Mutual funds	1,100	0	0	1,100	1,100	0	0
Commercial paper	1	0	0	1	1	0	0
Certificates of deposit	906	0	0	906	776	130	0
U.S. government and agency securities	72,843	76	(30)	72,889	39	72,850	0
Foreign government bonds	5,477	3	(24)	5,456	0	5,456	0
Mortgage- and asset-backed securities	4,899	23	(6)	4,916	0	4,916	0
Corporate notes and bonds	7,192	97	(37)	7,252	0	7,252	0
Municipal securities	285	35	(1)	319	0	319	0
Common and preferred stock	6,668	4,986	(215)	11,439	0	0	11,439
Other investments	597	0	0	597	0	8	589
Total	$ 103,647	$ 5,220	$ (313)	$ 108,554	$ 5,595	$ 90,931	$ 12,028

As of December 31, 2015 and June 30, 2015, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $727 million and $561 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

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 sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. As of December 31, 2015, the collateral received under these agreements totaled $439 million which is 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		Total	
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
December 31, 2015						
U.S. government and agency securities	**$ 72,914**	**$ (202)**	**$ 566**	**$ (30)**	**$ 73,480**	**$ (232)**
Foreign government bonds	**3,635**	**(9)**	**52**	**(30)**	**3,687**	**(39)**
Mortgage- and asset-backed securities	**3,428**	**(9)**	**329**	**0**	**3,757**	**(9)**

Corporate notes and bonds	**4,168**	**(68)**	**377**	**(38)**	**4,545**	**(106)**
Common and preferred stock	**1,329**	**(225)**	**440**	**(108)**	**1,769**	**(333)**
Total	**$ 85,474**	**$ (513)**	**$ 1,764**	**$ (206)**	**$ 87,238**	**$ (719)**

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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, 2015						
U.S. government and agency securities	$ 6,636	$ (9)	$ 421	$ (21)	$ 7,057	$ (30)
Foreign government bonds	4,611	(12)	18	(12)	4,629	(24)
Mortgage- and asset-backed securities	3,171	(5)	28	(1)	3,199	(6)
Corporate notes and bonds	2,946	(29)	104	(8)	3,050	(37)
Municipal securities	36	(1)	0	0	36	(1)
Common and preferred stock	1,389	(180)	148	(35)	1,537	(215)
Total	$ 18,789	$ (236)	$ 719	$ (77)	$ 19,508	$ (313)

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
December 31, 2015		
Due in one year or less	$ 36,522	$ 36,479
Due after one year through five years	57,639	57,461
Due after five years through 10 years	2,519	2,441
Due after 10 years	1,306	1,351
Total	$ 97,986	$ 97,732

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 December 31, 2015 and June 30, 2015, the total notional amounts of these foreign exchange contracts sold were $9.5 billion and $9.8 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair-value hedging instruments. As of December 31, 2015 and June 30, 2015, the total notional amounts of these foreign exchange contracts sold were $4.7 billion and $5.3 billion, respectively.

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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 December 31, 2015, the total notional amounts of these foreign exchange contracts purchased and sold were $8.2 billion and $6.2 billion, respectively. As of June 30, 2015, the total notional amounts of these foreign exchange contracts purchased and sold were $9.7 billion and $11.0 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 December 31, 2015, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.6 billion and $2.3 billion, respectively, of which $733 million and $1.0 billion, respectively, were designated as hedging instruments. As of June 30, 2015, the total notional amounts of equity contracts purchased and sold for managing market price risk were $2.2 billion and $2.6 billion, respectively, of which $1.1 billion and $1.4 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 December 31, 2015, the total notional amounts of fixed-interest rate contracts purchased and sold were $460 million and $2.8 billion, respectively. As of June 30, 2015, the total notional amounts of fixed-interest rate contracts purchased and sold were $1.0 billion and $3.2 billion, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of December 31, 2015 and June 30, 2015, the total notional derivative amounts of mortgage contracts purchased were $602 million and $812 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 December 31, 2015, the total notional amounts of credit contracts purchased and sold were $525 million and $428 million, respectively. As of June 30, 2015, the total notional amounts of credit contracts purchased and sold were $618 million and $430 million, respectively.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swaps, futures, and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of December 31, 2015, the total notional amounts of commodity contracts purchased and sold were $642 million and $194 million, respectively. As of June 30, 2015, the total notional amounts of commodity contracts purchased and sold were $882 million and $316 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of December 31, 2015, 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.

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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.

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, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are reclassified from accumulated other comprehensive income (AOCI) into other income (expense), net.

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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:

	December 31, 2015				June 30, 2015			
		Assets		Liabilities		Assets		Liabilities
(In millions)	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities
Non-designated Hedge Derivatives								
Foreign exchange contracts	**$ 19**	**$ 109**	**$ 0**	**$ (141)**	$ 17	$ 167	$ 0	$ (79)
Equity contracts	**135**	**0**	**0**	**(21)**	148	0	0	(18)
Interest rate contracts	**5**	**0**	**0**	**(15)**	7	0	0	(12)
Credit contracts	**9**	**0**	**0**	**(7)**	16	0	0	(9)
Commodity contracts	**1**	**0**	**0**	**(1)**	0	0	0	0
Total	**$ 169**	**$ 109**	**$ 0**	**$ (185)**	$ 188	$ 167	$ 0	$ (118)
Designated Hedge Derivatives								
Foreign exchange contracts	**$ 17**	**$ 632**	**$ 0**	**$ (57)**	$ 56	$ 552	$ 0	$ (31)
Equity contracts	**0**	**0**	**10**	**(29)**	0	0	25	(69)
Total	**$ 17**	**$ 632**	**$ 10**	**$ (86)**	$ 56	$ 552	$ 25	$ (100)
Total gross amounts of derivatives	**$ 186**	**$ 741**	**$ 10**	**$ (271)**	$ 244	$ 719	$ 25	$ (218)
Gross derivatives either offset or subject to an enforceable master netting agreement	**$ 74**	**$ 741**	**$ 10**	**$ (269)**	$ 126	$ 719	$ 25	$ (218)
Gross amounts of derivatives offset in the balance sheet	**(108)**	**(113)**	**(10)**	**231**	(66)	(71)	(25)	161
Net amounts presented in the balance sheet	**(34)**	**628**	**0**	**(38)**	60	648	0	(57)
Gross amounts of derivatives not offset in the balance sheet	**0**	**0**	**0**	**0**	0	0	0	0
Cash collateral received	**0**	**0**	**0**	**(330)**	0	0	0	(456)
Net amount	**$ (34)**	**$ 628**	**$ 0**	**$ (368)**	$ 60	$ 648	$ 0	$ (513)

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

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Fair-Value Hedge Gains (Losses)

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Foreign Exchange Contracts				
Derivatives	**$ 48**	$ 381	**$ (33)**	$ 622
Hedged items	**(41)**	(382)	**50**	(624)
Total amount of ineffectiveness	**$ 7**	$ (1)	**$ 17**	$ (2)
Equity Contracts				
Derivatives	**$ (59)**	$ 18	**$ (92)**	$ (63)
Hedged items	**59**	(18)	**92**	63
Total amount of ineffectiveness	**$ 0**	$ 0	**$ 0**	$ 0
Amount of equity contracts excluded from effectiveness assessment	**$ (15)**	$ (9)	**$ 4**	$ (13)

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 December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Effective Portion				
Gains recognized in OCI (net of tax effects of **$15**, $8, **$43,** and $12)	**$ 122**	$ 357	**$ 283**	$ 692
Gains reclassified from AOCI into revenue	**181**	112	**290**	128
Amount Excluded from Effectiveness Assessment and Ineffective Portion				
Losses recognized in other income (expense), net	**(72)**	(74)	**(154)**	(142)

We estimate that $509 million of net derivative gains included in AOCI at December 31, 2015 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during the three and six months ended December 31, 2015.

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Non-Designated Derivative Gains (Losses)

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense), 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, such as commodity contracts, 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 December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Foreign exchange contracts	**$ (134)**	$ 28	**$ (75)**	$ (205)
Equity contracts	**(30)**	(24)	**4**	(14)
Interest-rate contracts	**9**	24	**8**	18
Credit contracts	**2**	1	**(3)**	(4)
Commodity contracts	**(52)**	(106)	**(136)**	(217)
Total	**$ (205)**	$ (77)	**$ (202)**	$ (422)

NOTE 6 FAIR VALUE MEASUREMENTS

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

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

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

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

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
December 31, 2015						
Assets						
Mutual funds	**$ 1,428**	**$ 0**	**$ 0**	**$ 1,428**	**$ 0**	**$ 1,428**
Commercial paper	**0**	**790**	**0**	**790**	**0**	**790**
Certificates of deposit	**0**	**1,062**	**0**	**1,062**	**0**	**1,062**
U.S. government and agency securities	**75,122**	**3,773**	**0**	**78,895**	**0**	**78,895**
Foreign government bonds	**68**	**4,907**	**0**	**4,975**	**0**	**4,975**
Mortgage- and asset-backed securities	**0**	**4,858**	**0**	**4,858**	**0**	**4,858**
Corporate notes and bonds	**0**	**6,728**	**1**	**6,729**	**0**	**6,729**
Municipal securities	**0**	**321**	**0**	**321**	**0**	**321**
Common and preferred stock	**7,981**	**2,216**	**18**	**10,215**	**0**	**10,215**
Derivatives	**6**	**931**	**0**	**937**	**(231)**	**706**
Total	**$ 84,605**	**$ 25,586**	**$ 19**	**$ 110,210**	**$ (231)**	**$ 109,979**
Liabilities						
Derivatives and other	**$ 4**	**$ 267**	**$ 0**	**$ 271**	**$ (231)**	**$ 40**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[a]	Net Fair Value
June 30, 2015						
Assets						
Mutual funds	$ 1,100	$ 0	$ 0	$ 1,100	$ 0	$ 1,100
Commercial paper	0	1	0	1	0	1
Certificates of deposit	0	906	0	906	0	906
U.S. government and agency securities	71,930	955	0	72,885	0	72,885
Foreign government bonds	131	5,299	0	5,430	0	5,430
Mortgage- and asset-backed securities	0	4,917	0	4,917	0	4,917

Corporate notes and bonds	0	7,108	1	7,109	0	7,109
Municipal securities	0	319	0	319	0	319
Common and preferred stock	8,585	2,277	14	10,876	0	10,876
Derivatives	4	979	5	988	(162)	826
Total	$ 81,750	$ 22,761	$ 20	$ 104,531	$ (162)	$ 104,369
Liabilities						
Derivatives and other	$ 5	$ 159	$ 54	$ 218	$ (161)	$ 57

(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)

	December 31, 2015	June 30, 2015
Net fair value of assets measured at fair value on a recurring basis	**$ 109,979**	$ 104,369
Cash	**3,480**	3,679
Common and preferred stock measured at fair value on a nonrecurring basis	**727**	561
Other investments measured at fair value on a nonrecurring basis	**565**	589
Less derivative net assets classified as other current assets	**(628)**	(648)
Other	**6**	4
Recorded basis of investment components	**$ 114,129**	$ 108,554

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

During the three and six months ended December 31, 2015 and 2014, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)

	December 31, 2015	June 30, 2015
Raw materials	**$ 1,791**	$ 1,100
Work in process	**120**	202
Finished goods	**791**	1,600
Total	**$ 2,702**	$ 2,902

NOTE 8 BUSINESS COMBINATIONS

Mojang Synergies AB

On November 6, 2014, we acquired Mojang Synergies AB (Mojang), the Swedish video game developer of the Minecraft gaming franchise, for $2.5 billion in cash, net of cash acquired. The addition of Minecraft and its community enhances our gaming portfolio across Windows, Xbox, and other ecosystems besides our own. The significant classes of assets and liabilities to which we allocated the purchase price were goodwill of $1.8 billion and identifiable intangible assets of $928 million, primarily marketing-related (trade names). The goodwill recognized in connection with the acquisition is primarily attributable to anticipated synergies from future growth, and is not expected to be deductible for tax purposes. We assigned the goodwill to More Personal Computing under our current segment structure. Identifiable intangible assets were assigned a total weighted-average amortization period of 6.3 years. Mojang has been included in our consolidated results of operations since the acquisition date.

Other

During the six months ended December 31, 2015, we completed 12 acquisitions for total cash consideration of $782 million. These entities have been included in our consolidated results of operations since their respective acquisition dates.

Pro forma results of operations have not been presented because the effects of these business combinations, individually and in aggregate, were not material to our consolidated results of operations.

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NOTE 9 GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30, 2015	Acquisitions	Other	December 31, 2015
Productivity and Business Processes	**$ 6,309**	**$ 264**	**$ (69)**	**$ 6,504**
Intelligent Cloud	**4,917**	**244**	**(3)**	**5,158**
More Personal Computing	**5,713**	**90**	**(29)**	**5,774**
Total goodwill	**$ 16,939**	**$ 598**	**$ (101)**	**$ 17,436**

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

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.

As discussed in Note 18 Segment Information, during the first quarter of fiscal year 2016 the Company s chief operating decision maker requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. This resulted in a change in our operating segments and reporting units. We allocated goodwill to our new reporting units using a relative fair value approach. In addition, we completed an assessment of any potential goodwill impairment for all reporting units immediately prior to the reallocation and determined that no impairment existed.

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
			December 31, 2015			June 30, 2015
Technology-based [a]	**$ 6,880**	**$ (3,805)**	**$ 3,075**	$ 6,187	$ (3,410)	$ 2,777
Marketing-related	**1,955**	**(612)**	**1,343**	1,974	(540)	1,434
Contract-based	**797**	**(710)**	**87**	1,344	(862)	482

Customer-related	**608**	**(494)**	**114**	632	(490)	142
Total	**$ 10,240**	**$ (5,621)**	**$ 4,619**	$ 10,137	$ (5,302)	$ 4,835

(a) *Technology-based intangible assets included $147 million and $116 million as of December 31, 2015 and June 30, 2015, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

Intangible assets amortization expense was $249 million and $491 million for the three and six months ended December 31, 2015, respectively, and $329 million and $701 million for the three and six months ended December 31, 2014, respectively. Amortization of capitalized software was $18 million and $36 million for the three and six months ended December 31, 2015, respectively, and $15 million and $55 million for the three and six months ended December 31, 2014, respectively.

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The following table outlines the estimated future amortization expense related to intangible assets held at December 31, 2015:

(In millions)	
Year Ending June 30,	
2016 (excluding the six months ended December 31, 2015)	$ 487
2017	832
2018	727
2019	583
2020	519
Thereafter	1,471
Total	$ 4,619

NOTE 11 DEBT

Short-term Debt

As of December 31, 2015, we had $3.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.21% and maturities ranging from 77 days to 92 days. As of June 30, 2015, we had $5.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.11% and maturities ranging from 8 days to 63 days. The estimated fair value of this commercial paper approximates its carrying value.

In November 2015, we renewed our $5.0 billion credit facility set to expire on November 4, 2015. We currently have two $5.0 billion credit facilities that expire on November 1, 2016 and November 14, 2018, respectively. These credit facilities serve as a back-up for our commercial paper program. As of December 31, 2015, 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 December 31, 2015, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $41.4 billion and $42.1 billion, respectively. This is compared to a carrying value and estimated fair value of our long-term debt of $30.3 billion and $30.5 billion, respectively, as of June 30, 2015. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of December 31, 2015 and June 30, 2015:

Due Date	Face Value December 31, 2015	Face Value June 30, 2015	Stated Interest Rate	Effective Interest Rate
	(In millions)			
Notes				
September 25, 2015	**$ ***	$ 1,750	**1.625%**	**1.795%**
February 8, 2016	**750**	750	**2.500%**	**2.642%**
November 15, 2017	**600**	600	**0.875%**	**1.084%**
May 1, 2018	**450**	450	**1.000%**	**1.106%**
November 3, 2018 [a]	**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%**
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 [a]	**2,250**	*	**2.000%**	**2.093%**
February 8, 2021	**500**	500	**4.000%**	**4.082%**
December 6, 2021 [b]	**1,901**	1,950	**2.125%**	**2.233%**
February 12, 2022	**1,500**	1,500	**2.375%**	**2.466%**
November 3, 2022 [a]	**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%**
December 15, 2023	**1,500**	1,500	**3.625%**	**3.726%**
February 12, 2025	**2,250**	2,250	**2.700%**	**2.772%**
November 3, 2025 [a]	**3,000**	*	**3.125%**	**3.176%**
December 6, 2028 [b]	**1,901**	1,950	**3.125%**	**3.218%**
May 2, 2033 [b]	**598**	613	**2.625%**	**2.690%**
February 12, 2035	**1,500**	1,500	**3.500%**	**3.604%**
November 3, 2035 [a]	**1,000**	*	**4.200%**	**4.260%**
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 [a]	**3,000**	*	**4.450%**	**4.492%**
February 12, 2055	**2,250**	2,250	**4.000%**	**4.063%**
November 3, 2055 [a]	**1,000**	*	**4.750%**	**4.782%**
Total	**$ 41,600**	$ 30,463		

(a) *In November 2015, we issued $13.0 billion of debt securities.*

(b) *Euro-denominated debt securities.*

* *Not applicable*

The notes in the table above are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. As of December 31, 2015 and June 30, 2015, the aggregate unamortized discount for our long-term debt, including the current portion, was $171 million and $156 million, respectively.

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NOTE 12 INCOME TAXES

Our effective tax rate for the three months ended December 31, 2015 and 2014 was 15% and 25%, respectively, and 15% and 24% for the six months ended December 31, 2015 and 2014, 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.

This quarter s effective tax rate was lower than the prior year s second quarter effective tax rate, primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries driven by the deferral of Windows 10 revenue in the current period. The prior year s second quarter effective tax rate also included an Internal Revenue Service (IRS) audit adjustment and non-deductible operating losses. The current year-to-date effective tax rate was lower than the prior year-to-date effective tax rate, primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries driven by the deferral of Windows 10 revenue in the current period. The prior year-to-date effective tax rate also included an IRS audit adjustment, higher non-deductible operating losses, and restructuring charges.

Tax contingencies and other income tax liabilities were $12.3 billion and $12.1 billion as of December 31, 2015 and June 30, 2015, respectively, and are included in other long-term liabilities. This increase relates primarily to current period quarterly growth relating to intercompany transfer pricing adjustments, offset by a partial settlement of the IRS audit for tax years 2007 to 2009 in the first quarter of 2016. While we settled a portion of the 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. 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 December 31, 2015, 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 also continue to be subject to examination by the IRS for tax years 2004 to 2015.

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 2015, 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

Phone Hardware Integration

In July 2014, we announced a restructuring plan to simplify our organization and align the purchase of Nokia Corporation s (Nokia) Devices and Services business (NDS) with our company s overall strategy (the Phone Hardware Integration Plan). Pursuant to the Phone Hardware Integration Plan, we eliminated approximately 19,000 positions in fiscal year 2015, including approximately 13,000 professional and factory positions related to the NDS business. The actions associated with the Phone Hardware Integration Plan were completed as of June 30, 2015.

In connection with the Phone Hardware Integration Plan, we incurred restructuring charges of $132 million and $1.2 billion during the three and six months ended December 31, 2014, respectively, including severance expenses and other reorganization costs, primarily associated with our facilities consolidation. Total restructuring charges incurred under the Phone Hardware Integration Plan were $1.3 billion, all of which were recognized in fiscal year 2015.

Phone Hardware Restructuring

In June 2015, management approved a plan to restructure our phone business to better focus and align resources (the Phone Hardware Restructuring Plan), under which we will eliminate up to 7,800 positions in fiscal year 2016. The actions associated with the Phone Hardware Restructuring Plan are expected to be completed as of June 30, 2016.

To date, we have incurred restructuring charges of $780 million under the Phone Hardware Restructuring Plan, including severance expenses and other reorganization costs.

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Restructuring charges associated with these plans were included in impairment, integration, and restructuring expenses in our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment in Note 18 Segment Information.

Changes in the restructuring liability were as follows:

(In millions)	Severance	Asset Impairments and Other[(a)]	Total
Restructuring liability as of June 30, 2015	**$ 588**	**$ 249**	**$ 837**
Restructuring charges	**0**	**0**	**0**
Cash paid	**(288)**	**(72)**	**(360)**
Other	**(23)**	**0**	**(23)**
Restructuring liability as of December 31, 2015	**$ 277**	**$ 177**	**$ 454**

(a) *Asset Impairments and Other primarily reflects activities associated with the consolidation of our facilities and manufacturing operations, including asset write-downs as well as contract termination costs.*

NOTE 14 UNEARNED REVENUE

Unearned revenue by segment was as follows:

(In millions)	December 31, 2015	June 30, 2015
Productivity and Business Processes	**$ 10,110**	$ 11,643
Intelligent Cloud	**8,811**	10,346
More Personal Computing	**2,900**	3,246
Corporate and Other	**3,210**	83
Total	**$ 25,031**	$ 25,318

As of December 31, 2015, we deferred a net $3.0 billion in revenue related to Windows 10 and a net $191 million in revenue related to Halo 5. Revenue from Windows 10 and Halo 5 is primarily recognized upfront in the More Personal Computing segment, and the deferral and subsequent recognition of revenue is reflected in Corporate and Other.

NOTE 15 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 and many of the leading cell 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.

InterDigital patent litigation

InterDigital Technology Corporation and InterDigital Communications Corporation (collectively, IDT) filed four patent infringement cases against Nokia in the International Trade Commission (ITC) and in U.S. District Court for the District of Delaware between 2007 and 2013. We have been added to these cases as a defendant. IDT has cases pending against other defendants based on the same patents because most of the patents at issue allegedly relate to 3G and 4G wireless communications standards essential functionality. The cases involving us include three ITC investigations where IDT sought an order excluding importation of 3G and 4G phones into the U.S. and one active case in U.S. District Court in Delaware seeking an injunction and damages. Each of the ITC matters has been resolved in our favor. In September 2015, the United States Patent Trial and Appeal Board issued a final written

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decision that deemed unpatentable all asserted claims of the patent remaining at issue in the Delaware case in an *inter partes* review. IDT has appealed this decision to the U.S. Court of Appeals for the Federal Circuit. The Delaware case has been stayed pending final completion of the *inter partes* review (including appeals and any subsequent proceedings in the Patent Office). We filed an antitrust complaint against IDT in the District of Delaware in August 2015 asserting violations of Section 2 of the Sherman Act, alleging the unlawful exploitation of standard essential patents. IDT filed a motion to dismiss, which remains pending.

European copyright levies

We assumed from Nokia all potential liability due to Nokia s alleged failure to pay private copying 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 that Nokia 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 are pending in Germany and Austria, due to both the high volume of sales and high levy amounts sought in these countries. In December 2015, the industry group BITKOM, of which we are a member, reached a tentative settlement with the German collecting society for all claims from 2008 forward, leaving litigation only for the period 2004-2007 pending in Germany. In addition, the industry is engaged in settlement negotiations with the Austrian collecting society.

Other patent and intellectual property claims

In addition to these cases, there are approximately 65 other patent infringement cases pending against Microsoft.

Antitrust and Unfair Competition Claims

Three antitrust and unfair competition class action lawsuits were filed against us in British Columbia, Ontario, and Quebec, Canada on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products between 1999 and 2005.

In 2010, the court in the British Columbia case certified it as a class action. After the British Columbia Court of Appeal dismissed the case, in 2013 the Canadian Supreme Court reversed the appellate court and reinstated part of the British Columbia case, which is now scheduled for trial beginning in 2016. The other two cases are inactive.

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, and file verification issues related to Windows and Office software.

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 have assumed responsibility for these claims as part of the NDS acquisition 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 court granted in part defendants motion to exclude

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plaintiffs general causation experts. The plaintiffs filed an interlocutory appeal. The District of Columbia Court of Appeals agreed to hear *en banc* defendants interlocutory appeal challenging the standard for evaluating expert scientific evidence. Trial court proceedings are stayed pending resolution of the appeal.

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. Microsoft was served with the complaint in June 2014 and has been substituted for the Nokia defendants. The litigation is not yet active as several defendants remain to be served.

Other

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

As of December 31, 2015, we accrued aggregate legal liabilities of $550 million in other current liabilities and $10 million in other long-term liabilities. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $1.5 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 16 STOCKHOLDERS EQUITY

Share Repurchases

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Shares of common stock repurchased	**66**	43	**155**	86
Value of common stock repurchased	**$ 3,600**	$ 2,000	**$ 7,600**	$ 4,000

The above table excludes shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards. On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to $40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2015, $14.3 billion remained of our $40.0 billion share repurchase program. All repurchases were made using cash resources.

Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal Year 2016				
September 15, 2015	**$ 0.36**	**November 19, 2015**	**$ 2,868**	**December 10, 2015**
December 2, 2015	**$ 0.36**	**February 18, 2016**	**$ 2,853**	**March 10, 2016**

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Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal Year 2015				
September 16, 2014	$ 0.31	November 20, 2014	$ 2,547	December 11, 2014
December 3, 2014	$ 0.31	February 19, 2015	$ 2,532	March 12, 2015

The dividend declared on December 2, 2015 was included in other current liabilities as of December 31, 2015.

NOTE 17 ACCUMULATED OTHER COMPREHENSIVE INCOME

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Derivatives				
Accumulated other comprehensive income balance, beginning of period	**$ 647**	$ 350	**$ 590**	$ 31
Unrealized gains, net of tax effects of **$15**, $8, **$43**, and $12	**122**	357	**283**	692
Reclassification adjustments for gains included in revenue	**(181)**	(112)	**(290)**	(128)
Tax expense included in provision for income taxes	**10**	2	**15**	2
Amounts reclassified from accumulated other comprehensive income	**(171)**	(110)	**(275)**	(126)
Net current period other comprehensive income (loss)	**(49)**	247	**8**	566
Accumulated other comprehensive income balance, end of period	**$ 598**	$ 597	**$ 598**	$ 597
Investments				
Accumulated other comprehensive income balance, beginning of period	**$ 2,598**	$ 3,342	**$ 3,169**	$ 3,531
Unrealized gains (losses), net of tax effects of **$122**, $(12), **$(183)**, and $(86)	**228**	(24)	**(338)**	(162)
Reclassification adjustments for gains included in other income (expense), net	**(104)**	(319)	**(112)**	(398)
Tax expense included in provision for income taxes	**36**	112	**39**	140
Amounts reclassified from accumulated other comprehensive income	**(68)**	(207)	**(73)**	(258)
Net current period other comprehensive income (loss)	**160**	(231)	**(411)**	(420)
Accumulated other comprehensive income balance, end of period	**$ 2,758**	$ 3,111	**$ 2,758**	$ 3,111

Translation adjustments and other				
Accumulated other comprehensive income (loss) balance, beginning of period	**$ (1,507)**	$ 65	**$ (1,237)**	$ 146
Translation adjustments and other, net of tax effects of **$(9)**, $(211), **$(21)**, and $(258)	**(76)**	(390)	**(346)**	(471)
Accumulated other comprehensive loss balance, end of period	**$ (1,583)**	$ (325)	**$ (1,583)**	$ (325)
Accumulated other comprehensive income, end of period	**$ 1,773**	$ 3,383	**$ 1,773**	$ 3,383

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NOTE 18 SEGMENT INFORMATION

In its operation of the business, management, including our chief operating decision maker, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP.

In June 2015, we announced a change in organizational structure as part of our transformation in the mobile-first, cloud-first world. During the first quarter of fiscal year 2016, the Company s chief operating decision maker requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. As a result, beginning in fiscal year 2016, we report our financial performance based on our new segments, Productivity and Business Processes, Intelligent Cloud, and More Personal Computing, and analyze operating income as the measure of segment profitability. We have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance.

Our reportable segments are described below.

Productivity and Business Processes

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

Office Commercial, including volume licensing and subscriptions to Office 365 Commercial for products and cloud services such as Microsoft Office, Exchange, SharePoint, and Skype for Business, and related Client Access Licenses (CALs).

Office Consumer, including Office sold through retail or through an Office 365 Consumer subscription, and Office Consumer Services, including Outlook.com, OneDrive, and consumer Skype services.

Microsoft Dynamics business solutions, including Dynamics ERP products, Dynamics CRM on-premises, and Dynamics CRM Online (Microsoft Dynamics).

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 Windows Server, Microsoft SQL Server, Visual Studio, System Center, and related CALs, as well as Microsoft 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 information technology professionals across screens of all sizes. This segment primarily comprises:

Windows, including Windows original equipment manufacturer licensing (Windows OEM) and other non-volume licensing of the Windows operating system, volume licensing of the Windows operating system, patent licensing, Windows Embedded, MSN display advertising, and Windows Phone licensing.

Devices, including phones, Surface, and Microsoft PC accessories.

Gaming, including Xbox hardware; Xbox Live, comprising transactions, subscriptions, and advertising; 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 on 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.

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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.

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Revenue				
Productivity and Business Processes	**$ 6,690**	$ 6,822	**$ 12,990**	$ 13,312
Intelligent Cloud	**6,343**	6,041	**12,232**	11,516
More Personal Computing	**12,660**	13,282	**22,114**	24,548
Corporate and Other	**(1,897)**	325	**(3,161)**	295
Total revenue	**$ 23,796**	$ 26,470	**$ 44,175**	$ 49,671

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Operating income (loss)				
Productivity and Business Processes	**$ 3,305**	$ 3,587	**$ 6,460**	$ 6,988
Intelligent Cloud	**2,580**	2,600	**4,977**	4,705
More Personal Computing	**2,038**	1,506	**3,542**	3,014
Corporate and Other	**(1,897)**	83	**(3,160)**	(1,087)
Total operating income	**$ 6,026**	$ 7,776	**$ 11,819**	$ 13,620

Corporate and Other operating income (loss) includes adjustments to conform our internal accounting policies to U.S. GAAP, and impairment, integration, and restructuring expenses. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition.

Corporate and Other operating income (loss) activity was as follows during the periods presented:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Revenue reconciling amounts and other [(a)]	**$ (1,897)**	$ 326	**$ (3,160)**	$ 296
Impairment, integration, and restructuring expenses	**0**	(243)	**0**	(1,383)
Total Corporate and Other	**$ (1,897)**	$ 83	**$ (3,160)**	$ (1,087)

(a) *Revenue reconciling amounts and other for the three months ended December 31, 2015 included a net $1.7 billion of revenue deferrals related to sales of Windows 10 and a net $191 million of revenue deferrals related to Halo 5. Revenue reconciling amounts and other for the three months ended December 31, 2014 included the net recognition of $326 million of previously deferred revenue related to sales of bundled products and services (Bundled Offerings).*

Revenue reconciling amounts and other for the six months ended December 31, 2015 included a net $3.0 billion of revenue deferrals related to sales of Windows 10 and a net $191 million of revenue deferrals related to Halo 5. Revenue reconciling amounts and other for the six months ended December 31, 2014 included the net recognition of $297 million of previously deferred revenue related to Bundled Offerings.

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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, and 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.

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 December 31, 2015, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders equity for the three-month and six-month periods ended December 31, 2015 and 2014. 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, 2015, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders equity for the year then ended (not presented herein); and in our report dated July 31, 2015 (October 26, 2015 as to the effects of the retrospective adjustments in Note 1, 10, 15, and 22) we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2015 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Seattle, Washington

January 28, 2016

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

Note About Forward-Looking Statements

This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: Management s Discussion and Analysis, and Risk Factors. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, will likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in Risk Factors (Part II, Item 1A of this Form 10-Q), Quantitative and Qualitative Disclosures about Market Risk (Part I, Item 3 of this Form 10-Q), and Management s Discussion and Analysis (Part I, Item 2 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.

OVERVIEW

The following Management s Discussion and Analysis (MD&A) is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our Annual Report on Form 10-K for the year ended June 30, 2015, our Form 8-K filed on October 27, 2015, and our consolidated financial statements and the accompanying Notes to Financial Statements in this Form 10-Q.

Microsoft is a technology leader focused on building best-in-class platforms and productivity services for a mobile-first, cloud-first world. We strive to empower every person and every organization on the planet to achieve more. We develop and market software, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people s lives.

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

In July 2015, we announced a restructuring of our phone business, including the creation of the Windows and Devices Group. This reinforces our strategy to create a vibrant Windows ecosystem with a single set of experiences across our first-party device family and original equipment manufacturer (OEM) offerings. Part of this strategy involves focusing our phone devices on a narrower range of customer categories and differentiating through the combination of hardware and software we are uniquely positioned to offer. Our change in strategy for the phone business is expected to result in a reduction in units sold and associated expenses.

Highlights from the second quarter of fiscal year 2016 included:

- Our commercial cloud, which primarily comprises Office 365 Commercial, Microsoft Azure, and Dynamics CRM Online, reached an annualized run rate* exceeding $9.4 billion.

Office 365 Consumer subscribers increased to 20.6 million.

Dynamics CRM Online seats more than doubled year-over-year.

Microsoft Azure revenue from premium services nearly tripled year-over-year, and over one third of the Fortune 500 have Enterprise Mobility, nearly tripling year-over-year.

Windows 10 is now running on more than 200 million devices around the world.

Xbox Live monthly active users grew 30% year-over-year to 48 million.

* *Annualized run rate was calculated by multiplying December 2015 revenue by twelve months.*

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Industry Trends

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

Economic Conditions, Challenges, and Risks

The market for software, devices, and cloud-based services is 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 devices and infrastructure 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. The strengthening of the U.S. dollar relative to certain foreign currencies throughout fiscal year 2015, and continuing into fiscal year 2016, negatively impacted reported revenue and reduced reported expenses from our international operations in the current period as compared to the prior year.

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

Seasonality

Our revenue historically has fluctuated quarterly and has generally been highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers.

Unearned Revenue

Quarterly and annual revenue is impacted by the deferral of revenue, primarily including:

Revenue deferred on Windows 10 licenses to reflect ratable recognition over the life of the device.

Revenue deferred on bundled products and services (Bundled Offerings).

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.

Reportable Segments

The segment amounts included in MD&A are presented on a basis consistent with our internal management reporting. Segment information appearing in Note 18 Segment Information of the Notes to Financial Statements is also presented on this basis. 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.

In June 2015, we announced a change in organizational structure as part of our transformation in the mobile-first, cloud-first world. During the first quarter of fiscal year 2016, the Company s chief operating decision maker, who is also our Chief Executive Officer, requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. As a result, beginning in fiscal year 2016, we report our financial performance

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based on our new segments, Productivity and Business Processes, Intelligent Cloud, and More Personal Computing, and analyze operating income as the measure of segment profitability. We have recast certain previously reported amounts to conform to the way we internally manage and monitor segment performance.

Our reportable segments are described below.

Productivity and Business Processes

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

- Office Commercial, including volume licensing and subscriptions to Office 365 Commercial for products and cloud services such as Microsoft Office, Exchange, SharePoint, and Skype for Business, and related Client Access Licenses (CALs).
- Office Consumer, including Office sold through retail or through an Office 365 Consumer subscription, and Office Consumer Services, including Outlook.com, OneDrive, and consumer Skype services.
- Microsoft Dynamics business solutions, including Dynamics ERP products, Dynamics CRM on-premises, and Dynamics CRM Online (Microsoft Dynamics).

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 Windows Server, Microsoft SQL Server, Visual Studio, System Center, and related CALs, as well as Microsoft 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 information technology professionals across screens of all sizes. This segment primarily comprises:

- Windows, including Windows OEM licensing (Windows OEM) and other non-volume licensing of the Windows operating system, volume licensing of the Windows operating system, patent licensing, Windows Embedded, MSN display advertising, and Windows Phone licensing.

Devices, including phones, Surface, and Microsoft PC accessories.

Gaming, including Xbox hardware; Xbox Live, comprising transactions, subscriptions, and advertising; video games; and third-party video game royalties.

Search advertising.

SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2015	2014		2015	2014	
Revenue	**$ 23,796**	$ 26,470	(10)%	**$ 44,175**	$ 49,671	(11)%
Gross margin	**$ 13,924**	$ 16,334	(15)%	**$ 27,096**	$ 31,262	(13)%
Operating income	**$ 6,026**	$ 7,776	(23)%	**$ 11,819**	$ 13,620	(13)%
Diluted earnings per share	**$ 0.62**	$ 0.71	(13)%	**$ 1.20**	$ 1.25	(4)%

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Three months ended December 31, 2015 compared with three months ended December 31, 2014

Revenue decreased $2.7 billion or 10%, primarily due to the impact of a net revenue deferral related to Windows 10 of $1.7 billion and an unfavorable foreign currency impact of approximately $1.2 billion or 5%. Windows 10 revenue is primarily recognized upfront in the More Personal Computing segment and the deferral and subsequent recognition of revenue is reflected in Corporate and Other. More Personal Computing revenue decreased, primarily due to lower revenue from Devices and Windows, offset in part by growth in Gaming and search advertising revenue. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services, including Microsoft Azure, as well as higher Enterprise Services revenue.

Operating income decreased $1.8 billion or 23%, primarily due to lower gross margin, offset in part by a reduction in operating expenses in the current year, driven by a reduction in phone expenses, and impairment, integration, and restructuring expenses in the prior year. Gross margin decreased $2.4 billion or 15%, driven by the impact of a net $1.7 billion revenue deferral related to Windows 10 and an unfavorable foreign currency impact of approximately $1.0 billion or 6%. Productivity and Business Processes gross margin decreased, offset in part by higher gross margin from Intelligent Cloud.

Key changes in expenses were:

Cost of revenue decreased $264 million or 3%, mainly due to lower phone sales, offset in part by growth in our commercial cloud and search advertising.

Sales and marketing expenses decreased $355 million or 8%, primarily driven by a reduction in phone expenses and a favorable foreign currency impact of approximately 4%.

Impairment, integration, and restructuring expenses were $243 million in the prior year, comprised mainly of restructuring charges associated with our July 2014 restructuring plan to simplify our organization and align the purchase of Nokia Corporation s Devices and Services business (NDS) with our overall strategy (Phone Hardware Integration Plan).

Diluted earnings per share (EPS) was $0.62 for the three months ended December 31, 2015. Current year diluted EPS was negatively impacted by revenue deferrals, primarily related to Windows 10 and Halo 5, which resulted in a decrease to diluted EPS of $0.16. Diluted EPS was $0.71 for the three months ended December 31, 2014. Prior year diluted EPS was favorably impacted by the recognition of previously deferred net revenue related to Bundled Offerings, and negatively impacted by impairment, integration, and restructuring expenses, which resulted in a net increase to diluted EPS of $0.01.

Six months ended December 31, 2015 compared with six months ended December 31, 2014

Revenue decreased $5.5 billion or 11%, primarily due to the impact of a net revenue deferral related to Windows 10 of $3.0 billion and an unfavorable foreign currency impact of approximately $2.4 billion or 5%. More Personal Computing revenue decreased, primarily due to lower revenue from Devices and Windows, offset in part by revenue growth in search advertising and Gaming. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services, including Microsoft Azure, as well as higher Enterprise Services revenue.

Operating income decreased $1.8 billion or 13%, primarily due to lower gross margin, offset in part by prior year impairment, integration, and restructuring expenses and a reduction in operating expenses in the current year, driven by a reduction in phone expenses. Gross margin decreased $4.2 billion or 13%, driven by the impact of a net $3.0 billion revenue deferral related to Windows 10 and an unfavorable foreign currency impact of approximately $2.0 billion or 6%. Productivity and Business Processes and More Personal Computing gross margin decreased, offset in part by higher gross margin from Intelligent Cloud.

Key changes in expenses were:

Cost of revenue decreased $1.3 billion or 7%, mainly due to lower phone sales, offset in part by growth in our commercial cloud.

Impairment, integration, and restructuring expenses were $1.4 billion in the prior year, comprised mainly of restructuring charges associated with our Phone Hardware Integration Plan.

Sales and marketing expenses decreased $750 million or 9%, primarily driven by a reduction in phone expenses and a favorable foreign currency impact of approximately 4%.

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Diluted EPS was $1.20 for the six months ended December 31, 2015. Current year diluted EPS was negatively impacted by revenue deferrals, primarily related to Windows 10 and Halo 5, which resulted in a decrease to diluted EPS of $0.25. Diluted EPS was $1.25 for the six months ended December 31, 2014. Prior year diluted EPS was favorably impacted by the recognition of previously deferred net revenue related to Bundled Offerings, and negatively impacted by impairment, integration, and restructuring expenses, which resulted in a net decrease to diluted EPS of $0.11.

SEGMENT RESULTS OF OPERATIONS

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2015	2014		2015	2014	
Revenue						
Productivity and Business Processes	**$ 6,690**	$ 6,822	(2)%	**$ 12,990**	$ 13,312	(2)%
Intelligent Cloud	**6,343**	6,041	5%	**12,232**	11,516	6%
More Personal Computing	**12,660**	13,282	(5)%	**22,114**	24,548	(10)%
Corporate and Other	**(1,897)**	325	*	**(3,161)**	295	*
Total revenue	**$ 23,796**	$ 26,470	(10)%	**$ 44,175**	$ 49,671	(11)%
Operating income (loss)						
Productivity and Business Processes	**$ 3,305**	$ 3,587	(8)%	**$ 6,460**	$ 6,988	(8)%
Intelligent Cloud	**2,580**	2,600	(1)%	**4,977**	4,705	6%
More Personal Computing	**2,038**	1,506	35%	**3,542**	3,014	18%
Corporate and Other	**(1,897)**	83	*	**(3,160)**	(1,087)	*
Total operating income	**$ 6,026**	$ 7,776	(23)%	**$ 11,819**	$ 13,620	(13)%

* *Not meaningful.*

Reportable Segments

Three months ended December 31, 2015 compared with three months ended December 31, 2014

Productivity and Business Processes

Productivity and Business Processes revenue decreased $132 million or 2%, primarily due to an unfavorable foreign currency impact of approximately 7%.

Office Consumer revenue decreased $107 million or 14%, driven by an unfavorable foreign currency impact of approximately 6% and a decline in the consumer PC market, offset in part by revenue growth from Office 365 Consumer, mainly due to recurring subscriptions, and a higher percentage of PCs with Office.

Office Commercial revenue decreased $36 million or 1%, driven by an unfavorable foreign currency impact of approximately 6%. Revenue from Office 365 Commercial increased, mainly due to growth in subscribers and higher premium mix, offset in part by lower transactional license volume, reflecting a continued shift to Office 365 Commercial and a decline in the business PC market.

Microsoft Dynamics revenue increased 3%, mainly due to higher revenue from Dynamics CRM Online, driven by seat growth. Microsoft Dynamics revenue included an unfavorable foreign currency impact of approximately 8%.

Productivity and Business Processes operating income decreased $282 million or 8%, driven by lower gross margin, offset in part by lower operating expenses. Gross margin decreased $353 million or 6%, primarily due to higher cost of revenue, as well as the decline in Office revenue. Gross margin included an unfavorable foreign currency impact of approximately 7%. Cost of revenue increased $221 million or 23%, primarily due to the increasing cloud mix of revenue and higher datacenter costs to deliver cloud services. Operating expenses decreased $71 million or 3%.

Intelligent Cloud

Intelligent Cloud revenue increased $302 million or 5%, mainly due to higher server products and cloud services revenue, as well as higher Enterprise Services revenue. Intelligent Cloud revenue included an unfavorable foreign currency impact of approximately 6%. Our server products and cloud services revenue grew $153 million or 3%, driven by revenue growth from Microsoft Azure of 127% and higher revenue from Microsoft SQL Server, offset in part by lower revenue from Windows Server. Server products and services revenue included an unfavorable foreign currency impact of approximately 7%. Enterprise Services revenue grew $123 million or 10%, mainly due to growth in Premier Support Services.

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Intelligent Cloud operating income decreased slightly, primarily due to higher operating expenses, offset in part by higher gross margin. Operating expenses increased $212 million or 11%, mainly due to higher research and development expenses of $145 million or 23%, driven by headcount-related expenses. Gross margin increased $192 million or 4%, driven by revenue growth from our server products and cloud services. Gross margin included an unfavorable foreign currency impact of approximately 7%. Cost of revenue increased $110 million or 7%, primarily driven by Microsoft Azure.

More Personal Computing

More Personal Computing revenue decreased $622 million or 5%, mainly due to lower revenue from Devices and Windows, offset in part by higher revenue from Gaming and search advertising. More Personal Computing revenue included an unfavorable foreign currency impact of approximately 3%.

Devices revenue decreased $896 million or 26%, mainly due to lower phone revenue, driven by a shift in strategy for the phone business, offset in part by higher Surface revenue. Phone revenue decreased $1.2 billion or 53%, as we sold 4.5 million Lumia phones and 22.5 million other phones in the second quarter of fiscal year 2016, compared with 10.5 million and 39.7 million sold, respectively, in the prior year. Surface revenue increased $248 million or 22%, primarily driven by the release of Surface Book and Surface Pro 4 in the second quarter of fiscal year 2016, offset in part by a decline in revenue from Surface Pro 3.

Windows revenue decreased $426 million or 8%, mainly due to lower revenue from patent licensing and Windows OEM. Patent licensing revenue decreased $161 million, due to a decline in units and patent revenue per license. Windows OEM revenue decreased $138 million or 5%, driven by declines in the business and consumer PC markets. Windows OEM Pro revenue declined 6%, driven by a decline in the business PC market. Windows OEM non-Pro revenue declined 3%, outperforming the consumer PC market, driven by a higher mix of premium licenses sold.

Gaming revenue increased $192 million or 5%, primarily due to higher revenue from Xbox Live and video games, offset in part by lower Xbox hardware revenue. Xbox Live revenue increased 24%, driven by both higher volumes of transactions and higher revenue per transaction. Video games revenue grew 47%, driven by the Halo 5 launch in October 2015 and sales of Minecraft. We acquired Mojang AB, the Swedish video game developer of the Minecraft gaming franchise, in November 2014. Xbox hardware revenue decreased 9%, mainly due to a decline in Xbox 360 console volume. Xbox One revenue decreased slightly due to higher console volume, offset by lower prices of consoles sold.

Search advertising revenue, excluding traffic acquisition costs, increased $109 million or 17%, primarily driven by growth in Bing, due to higher revenue per search and higher search volume.

More Personal Computing operating income increased $532 million or 35%, primarily due to lower operating expenses.

Gross margin decreased slightly, reflecting lower revenue, primarily as a result of lower phone sales, offset in part by a reduction in cost of revenue. Gross margin included an unfavorable foreign currency impact of approximately 6%. Cost of revenue decreased $593 million or 8%, primarily due to lower Devices cost of revenue, driven by a reduction in phone sales.

Operating expenses decreased $561 million or 14%, mainly due to lower sales and marketing expenses and research and development expenses. Sales and marketing expenses decreased $359 million or 18%, driven by a reduction in phone expenses, partially offset by marketing expenses associated with the launch of Surface Pro 4, Surface Book, and Windows 10. Research and development expenses decreased $179 million or 11%, mainly due to a reduction in phone expenses.

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Six months ended December 31, 2015 compared with six months ended December 31, 2014

Productivity and Business Processes

Productivity and Business Processes revenue decreased $322 million or 2%, primarily due to an unfavorable foreign currency impact of approximately 6%.

Office Consumer revenue decreased $216 million or 13%, driven by an unfavorable foreign currency impact of approximately 7% and a decline in the consumer PC market, offset in part by revenue growth from Office 365 Consumer, mainly due to recurring subscriptions.

Office Commercial revenue decreased $134 million or 1%, driven by an unfavorable foreign currency impact of approximately 6%. Revenue from Office 365 Commercial increased, mainly due to growth in subscribers and higher premium mix, offset in part by lower transactional license volume, reflecting a continued shift to Office 365 Commercial and a decline in the business PC market.

Microsoft Dynamics revenue increased 3%, mainly due to higher revenue from Dynamics CRM Online, driven by seat growth. Microsoft Dynamics revenue included an unfavorable foreign currency impact of approximately 8%.

Productivity and Business Processes operating income decreased $528 million or 8%, driven by lower gross margin, offset in part by a reduction in operating expenses. Gross margin decreased $723 million or 6%, primarily due to the decline in Office revenue, as well as higher cost of revenue. Gross margin included an unfavorable foreign currency impact of approximately 7%. Cost of revenue increased $401 million or 22%, primarily due to the increasing cloud mix of revenue and higher datacenter costs to deliver cloud services. Operating expenses decreased $195 million or 4%, driven by lower sales and marketing expenses. Sales and marketing expenses decreased $136 million or 6%, mainly due to a reduction in headcount-related expenses and lower fees paid to third-party enterprise software advisors.

Intelligent Cloud

Intelligent Cloud revenue increased $716 million or 6%, mainly due to higher server products and cloud services revenue, as well as higher Enterprise Services revenue. Intelligent Cloud revenue included an unfavorable foreign currency impact of approximately 6%. Our server products and cloud services revenue grew $423 million or 5%, driven by revenue growth from Microsoft Azure of 124% and higher revenue from Microsoft SQL Server, offset in part by lower revenue from Windows Server. Server products and services revenue included an unfavorable foreign currency impact of approximately 6%. Enterprise Services revenue grew $239 million or 10%, mainly due to growth in Premier Support Services.

Intelligent Cloud operating income increased $272 million or 6%, primarily due to higher gross margin, offset in part by higher operating expenses. Gross margin increased $523 million or 6%, driven by revenue growth from our server products and cloud services. Gross margin included an unfavorable foreign currency impact of approximately 7%. Cost of revenue increased $193 million or 7%, primarily driven by Microsoft Azure. Operating expenses increased $251 million or 6%, mainly due to higher research and development expenses of $233 million or 18%, driven by headcount-related expenses.

More Personal Computing

More Personal Computing revenue decreased $2.4 billion or 10%, mainly due to lower revenue from Devices and Windows, offset in part by higher revenue from search advertising and Gaming. More Personal Computing revenue included an unfavorable foreign currency impact of approximately 3%.

Devices revenue decreased $2.7 billion or 37%, mainly due to lower revenue from phones. Phone revenue decreased $2.7 billion or 55%, as we sold 10.3 million Lumia phones and 48.0 million other phones during the six months ended December 31, 2015, compared with 19.9 million and 82.6 million sold, respectively, in the prior year. Surface revenue increased slightly, primarily driven by the release of Surface Book and Surface Pro 4 in the second quarter of fiscal year 2016, partially offset by a decline in revenue from Surface Pro 3.

Windows revenue decreased $739 million or 7%, mainly due to lower revenue from Windows OEM and patent licensing. Windows OEM revenue decreased $327 million or 5%, driven by declines in the business and consumer PC markets. Windows OEM Pro revenue declined 7%, driven by a decline in the business PC market. Windows OEM non-Pro revenue declined 3%, outperforming the consumer PC market, driven by a higher mix of premium licenses sold. Patent licensing revenue decreased $223 million, due to a decline in units and patent revenue per license.

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Search advertising revenue, excluding traffic acquisition costs, increased $236 million or 20%, primarily driven by growth in Bing, due to higher revenue per search and higher search volume.

Gaming revenue increased $221 million or 4%, as growth in revenue from Xbox Live and video games was offset in part by lower Xbox hardware revenue. Xbox Live revenue increased 21%, driven by both higher volumes of transactions and higher revenue per transaction. Video games revenue grew 52%, driven by sales of Minecraft and the launch of Halo 5. Xbox hardware revenue decreased 11%, mainly due to a decline in Xbox 360 console volume. Xbox One revenue decreased, due to higher console volume, offset by lower prices of consoles sold.

More Personal Computing operating income increased $528 million or 18%, primarily due to lower operating expenses, offset in part by lower gross margin.

Gross margin decreased $511 million or 5%, reflecting lower revenue, primarily as a result of lower phone sales, offset in part by a reduction in cost of revenue. Gross margin included an unfavorable foreign currency impact of approximately 6%. Cost of revenue decreased $1.9 billion or 14%, primarily due to lower Devices cost of revenue, driven by a reduction in phone sales.

Operating expenses decreased $1.0 billion or 13%, mainly due to lower sales and marketing expenses and research and development expenses. Sales and marketing expenses decreased $662 million or 18% and research and development expenses decreased $352 million or 10%, driven by a reduction in phone expenses.

Corporate and Other

Corporate and Other revenue primarily comprises certain revenue deferrals, including those related to Windows 10, Bundled Offerings, and video games. Corporate and Other operating income (loss) primarily comprises revenue deferrals and corporate-level activity not specifically allocated to a segment, including impairment, integration, and restructuring expenses.

Three months ended December 31, 2015 compared with three months ended December 31, 2014

Corporate and Other revenue decreased $2.2 billion, primarily due to the shift to ratable revenue recognition for Windows 10 in the current fiscal year. During the three months ended December 31, 2015, we deferred a net $1.7 billion of revenue related to Windows 10 and a net $191 million of revenue related to Halo 5. During the three months ended December 31, 2014, we recognized a net $326 million of previously deferred revenue related to Bundled Offerings.

Corporate and Other operating loss increased $2.0 billion, primarily due to decreased revenue, offset in part by $243 million of impairment, integration, and restructuring expenses in the prior year, reflecting costs associated with the acquisition of NDS.

Six months ended December 31, 2015 compared with six months ended December 31, 2014

Corporate and Other revenue decreased $3.5 billion, primarily due to the shift to ratable revenue recognition for Windows 10 in the current fiscal year. During the six months ended December 31, 2015, we deferred a net $3.0 billion of revenue related to Windows 10 and a net $191 million of revenue related to Halo 5. During the six months ended December 31, 2014, we recognized a net $297 million of previously deferred revenue related to Bundled Offerings.

Corporate and Other operating loss increased $2.1 billion, primarily due to decreased revenue, offset in part by $1.4 billion of impairment, integration, and restructuring expenses in the prior year.

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OPERATING EXPENSES

Research and Development

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2015	**2014**		**2015**	**2014**	
Research and development	**$ 2,900**	$ 2,903	0%	**$ 5,862**	$ 5,968	(2)%
As a percent of revenue	**12%**	11%	1ppt	**13%**	12%	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.

Three months ended December 31, 2015 compared with three months ended December 31, 2014

Research and development expenses were comparable to prior year.

Six months ended December 31, 2015 compared with six months ended December 31, 2014

Research and development expenses decreased $106 million or 2%, primarily driven by a reduction in phone expenses, partially offset by increased investment in Intelligent Cloud.

Sales and Marketing

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2015	**2014**		**2015**	**2014**	
Sales and marketing	**$ 3,960**	$ 4,315	(8)%	**$ 7,293**	$ 8,043	(9)%
As a percent of revenue	**17%**	16%	1ppt	**17%**	16%	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 December 31, 2015 compared with three months ended December 31, 2014

Sales and marketing expenses decreased $355 million or 8%, primarily driven by a reduction in phone expenses and a favorable foreign currency impact of approximately 4%.

Six months ended December 31, 2015 compared with six months ended December 31, 2014

Sales and marketing expenses decreased $750 million or 9%, primarily driven by a reduction in phone expenses and a favorable foreign currency impact of approximately 4%.

General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2015	**2014**		**2015**	**2014**	
General and administrative	**$ 1,038**	$ 1,097	(5)%	**$ 2,122**	$ 2,248	(6)%
As a percent of revenue	**4%**	4%	0ppt	**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.

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Three months ended December 31, 2015 compared with three months ended December 31, 2014

General and administrative expenses decreased slightly.

Six months ended December 31, 2015 compared with three months ended December 31, 2014

General and administrative expenses decreased $126 million or 6%, mainly due to lower headcount-related expenses and a favorable foreign currency impact of approximately 3%.

IMPAIRMENT, INTEGRATION, AND RESTRUCTURING EXPENSES

Impairment, integration, and restructuring expenses include costs associated with the impairment of goodwill and intangible assets related to our phone hardware business, employee severance expenses and costs associated with the consolidation of facilities and manufacturing operations related to restructuring activities, and systems consolidation and other business integration expenses associated with our acquisition of NDS.

Three months ended December 31, 2015 compared with three months ended December 31, 2014

Impairment, integration, and restructuring expenses were $243 million during the three months ended December 31, 2014, comprised mainly of restructuring charges of $132 million, including the write-down of certain assets and employee severance expenses in connection with our Phone Hardware Integration Plan, and integration expenses of $111 million, primarily systems consolidation costs and employee-related expenses. See Note 13 Restructuring Charges of the Notes to Financial Statements for discussion of our restructuring plans.

Six months ended December 31, 2015 compared with six months ended December 31, 2014

Impairment, integration, and restructuring expenses were $1.4 billion during the six months ended December 31, 2014, comprised mainly of restructuring charges of $1.2 billion, including employee severance expenses and the write-down of certain assets in connection with our Phone Hardware Integration Plan.

OTHER INCOME (EXPENSE), NET

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	**2014**	**2015**	**2014**
Dividends and interest income	**$ 200**	$ 183	**$ 399**	$ 408
Interest expense	**(309)**	(162)	**(558)**	(323)
Net recognized gains on investments	**106**	317	**108**	396
Net losses on derivatives	**(156)**	(138)	**(259)**	(272)
Net gains (losses) on foreign currency remeasurements	**2**	83	**(34)**	161
Other	**(14)**	(209)	**(107)**	(244)
Total	**$ (171)**	$ 74	**$ (451)**	$ 126

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, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities and gains (losses) on certain balance sheet amounts from foreign exchange rate changes.

Three months ended December 31, 2015 compared with three months ended December 31, 2014

Dividends and interest income increased primarily due to higher portfolio balances. Interest expense increased primarily due to higher outstanding long-term debt. Net recognized gains on investments decreased primarily due to lower gains on sales of equity securities and higher other-than-temporary impairments. Other-than-temporary impairments were $127 million for the three months ended December 31, 2015, compared with $26 million in the prior year. Net losses on derivatives increased due to higher losses on foreign exchange and equity contracts and lower gains on interest rate contracts, offset in part by lower losses on commodity derivatives. Other during the prior period reflects recognized losses from divestitures and certain joint ventures.

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Interest expense increased due to higher outstanding long-term debt. Net recognized gains on investments decreased primarily due to lower gains on sales of equity securities and higher other-than-temporary impairments. Other-than-temporary impairments were $162 million for the six months ended December 31, 2015, compared with $35 million in the prior year. Net losses on derivatives decreased due to lower losses on commodity derivatives and gains on equity derivatives in the current period compared to losses in the prior period, offset in part by higher losses on foreign exchange contracts. Other during the prior period reflects recognized losses on divestitures and certain joint ventures.

INCOME TAXES

Our effective tax rate for the three months ended December 31, 2015 and 2014 was 15% and 25%, respectively, and 15% and 24% for the six months ended December 31, 2015 and 2014, 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.

This quarter s effective tax rate was lower than the prior year s second quarter effective tax rate, primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries driven by the deferral of Windows 10 revenue in the current period. The prior year s second quarter effective tax rate also included an Internal Revenue Service (IRS) audit adjustment and non-deductible operating losses. The current year-to-date effective tax rate was lower than the prior year-to-date effective tax rate, primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries driven by the deferral of Windows 10 revenue in the current period. The prior year-to-date effective tax rate also included an IRS audit adjustment, higher non-deductible operating losses, and restructuring charges.

On July 27, 2015, the U.S. Tax Court issued an opinion in Altera Corp. v. Commissioner related to the treatment of stock-based compensation expense in an intercompany cost-sharing arrangement. At this time, the U.S. Department of the Treasury has not withdrawn the requirement from its regulations to include stock-based compensation. We concluded that no adjustment to our consolidated financial statements is appropriate at this time due to the uncertainties with respect to the ultimate resolution of this case.

Tax contingencies and other income tax liabilities were $12.3 billion and $12.1 billion as of December 31, 2015 and June 30, 2015, respectively, and are included in other long-term liabilities. This increase relates primarily to current period quarterly growth relating to intercompany transfer pricing adjustments, offset by a partial settlement of the IRS audit for tax years 2007 to 2009 in the first quarter of 2016. While we settled a portion of the 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. 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 December 31, 2015, 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 also continue to be subject to examination by the IRS for tax years 2004 to 2015.

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 2015, 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 $102.6 billion as of December 31, 2015, compared with $96.5 billion as of June 30, 2015. Equity and other investments were $11.5 billion as of December 31, 2015

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compared with $12.1 billion as of June 30, 2015. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities in order to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities.

Of the cash, cash equivalents, and short-term investments at December 31, 2015, $96.3 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 $2.3 billion. As of December 31, 2015, approximately 81% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 5% were invested in corporate notes and bonds of U.S. companies, and approximately 5% were invested in U.S. mortgage- and asset-backed securities, all of which are denominated in U.S. dollars.

Securities lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our consolidated balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was $439 million as of December 31, 2015. Our average and maximum securities lending payable balances for the three months ended December 31, 2015 were $310 million and $1.2 billion, respectively. Our average and maximum securities lending payable balances for the six months ended December 31, 2015 were $256 million and $1.2 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 exchange-traded mutual funds, domestic and international equities, and U.S. government securities. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, common and preferred stock, foreign government bonds, mortgage- and asset-backed securities, U.S. government and agency securities, and certificates of deposit. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured at fair value on a recurring basis using unobservable inputs are an immaterial portion of our portfolio.

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

Cash Flows

Cash flows from operations increased $1.5 billion to $14.2 billion for the six months ended December 31, 2015, mainly due to lower operating expenditures. Cash used in financing increased $1.7 billion to $4.1 billion, mainly due to a $3.4 billion increase in cash used for common stock repurchases and a $489 million increase in dividends paid, offset in part by a $2.9 billion increase in proceeds from issuances of debt, net of

repayments. Cash used in investing decreased $4.1 billion to $8.4 billion, mainly due to a $2.2 billion decrease in cash used for acquisitions of companies and a $2.0 billion decrease in cash used for net investment purchases, sales, and maturities.

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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. See Note 11 Debt of the Notes to Financial Statements for further discussion.

Unearned Revenue

Unearned revenue at December 31, 2015 was comprised mainly of unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each coverage period and accounted for as subscriptions with revenue recognized ratably over the coverage period. Unearned revenue at December 31, 2015 also included payments for: Windows 10 licenses; post-delivery support and consulting services to be performed in the future; Xbox Live subscriptions and prepaid points; Office 365 subscriptions; Microsoft Dynamics business solutions products; Skype prepaid credits and subscriptions; Bundled Offerings; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of December 31, 2015:

(In millions)	
Three Months Ending,	
March 31, 2016	$ 9,357
June 30, 2016	6,483
September 30, 2016	3,300
December 31, 2016	1,789
Thereafter	4,102
Total	$ 25,031

Share Repurchases

During the three and six months ended December 31, 2015, we repurchased 66 million and 155 million, respectively, shares of our common stock for $3.6 billion and $7.6 billion, respectively, under a $40.0 billion share repurchase plan approved by our Board of Directors on September 16, 2013. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. While the program has no expiration date, we intend to complete it by December 31, 2016. As of December 31, 2015, $14.3 billion remained of our $40.0 billion share repurchase program. All repurchases were made using cash resources.

Dividends

See Note 16 Stockholders Equity of the Notes to Financial Statements 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. 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.

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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 in support of our productivity and platform strategy. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

Liquidity

We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. As a result, as discussed above under Cash, Cash Equivalents, and Investments, the majority of our cash, cash equivalents, and short-term investments are held by foreign subsidiaries. We currently do not intend nor foresee a need to repatriate these funds. We expect existing domestic cash, cash equivalents, short-term investments, 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

See Note 1 Accounting Policies of the Notes to Financial Statements 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

Revenue recognition for multiple-element arrangements requires judgment to determine if multiple elements exist, whether elements can be accounted for as separate units of accounting, and if so, the fair value for each of the elements.

Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. Certain volume licensing arrangements include a perpetual license for current products combined with rights to receive unspecified future versions of software products and are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period.

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

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Microsoft enters into arrangements that can include various combinations of software, services, and hardware. Where elements are delivered over different periods of time, and when allowed under U.S. GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement, and revenue is recognized as each element is delivered. We use a hierarchy to determine the fair value to be used for allocating revenue to elements: (i) vendor-specific objective evidence of fair value (VSOE), (ii) third-party evidence, and (iii) best estimate of selling price (ESP). For software elements, we follow the industry-specific software guidance which only allows for the use of VSOE in establishing fair value. Generally, VSOE is the price charged when the deliverable is sold separately or the price established by management for a product that is not yet sold if it is probable that the price will not change before introduction into the marketplace. ESPs are established as best estimates of what the selling prices would be if the deliverables were sold regularly on a stand-alone basis. Our process for determining ESPs requires judgment and considers multiple factors that may vary over time depending upon the unique facts and circumstances related to each deliverable.

In January 2015, we announced Windows 10 would be free to all qualified existing users of Windows 7 and Windows 8.1. This offer differs from historical offers preceding the launch of new versions of Windows as it is being made available for free to existing users in addition to new customers after the offer announcement. We evaluated the nature and accounting treatment of the Windows 10 offer and determined that it represents a marketing and promotional activity, in part because the offer is being made available for free to existing users. As this is a marketing and promotional activity, revenue recognition of new sales of Windows 8 will continue to be recognized as delivered.

Customers purchasing a Windows 10 license will receive unspecified updates and upgrades over the life of their Windows 10 device at no additional cost. As these updates and upgrades will not be sold on a stand-alone basis, we are unable to establish VSOE. Accordingly, revenue from licenses of Windows 10 is recognized ratably over the estimated life of the related device, which ranges between two to four years.

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.

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

Research and Development Costs

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

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. 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.

Income Taxes

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

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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, equity prices, and commodity 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.

Commodity

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

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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 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 as of December 31, 2015 and June 30, 2015 and for the three months ended December 31, 2015:

(In millions)

			Three Months Ended December 31,		
	December 31, 2015	**June 30, 2015**			**2015**
Risk Categories			**Average**	**High**	**Low**
Foreign currency	**$ 176**	$ 120	**$ 206**	**$ 227**	**$ 176**
Interest rate	**$ 60**	$ 51	**$ 58**	**$ 63**	**$ 52**
Equity	**$ 165**	$ 149	**$ 170**	**$ 175**	**$ 157**
Commodity	**$ 9**	$ 13	**$ 10**	**$ 11**	**$ 8**

Total one-day VaR for the combined risk categories was $292 million at December 31, 2015 and $237 million at June 30, 2015. The total VaR is 29% less at December 31, 2015 and June 30, 2015, respectively, than the sum of the separate risk categories in the table above due to the diversification benefit of the combination of risks.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 15 Contingencies of 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; however, our competitors in smartphones and tablets have established significantly larger user bases. Shifting a portion of our business to a vertically integrated model will increase our cost of revenue and reduce our operating margins.

We derive substantial revenue from licenses of Windows operating systems on personal computers. We face 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 OEM partners, which may affect their commitment to our platform.

The success of the Windows Phone platform is an important element of our goal to enhance personal productivity in a mobile-first and cloud-first world. The marketplace among mobile phone platforms is highly competitive. We may face issues in selecting, engaging, or securing support from operators and retailers for Windows phones due to, for instance, inadequate sales training or incentives, or insufficient marketing support for the Windows Phone platform.

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Competing platforms have application marketplaces (sometimes referred to as stores) with scale and significant installed bases. The variety and utility of applications available on a platform are important to device purchasing decisions. Users incur costs to move data and buy new 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 application marketplaces may increase our cost of revenue and lower our operating margins.

Business model competition

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

Even as we transition to a mobile-first and cloud-first strategy, 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 as a productivity and platform company for the mobile-first and cloud-first world. 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 increasing reliance on data-driven insights is becoming more important to the success of key opportunities in monetization, customer perceptions of quality, and operational efficiency. 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.

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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.

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, the Microsoft Office system, Bing, Windows Phone, Windows Server, the Windows Store, the Microsoft Azure Services platform, Office 365, other cloud-based services offerings, and the Xbox entertainment platform. We also invest in the development and acquisition of a variety of hardware for productivity, communication, and entertainment including PCs, tablets, phones, and gaming devices. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software 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.

The launch of Windows 10, with free upgrades available to existing users of Windows 7 and 8.1, constitutes the most ambitious update effort we have ever undertaken. We have done extensive preparation and compatibility testing for applications and devices to help ensure a positive experience for our users installing Windows 10. However, if users have a negative upgrade experience, or the community reacts negatively to the process we are following to promote and undertake the upgrades, the reception of Windows 10 in the marketplace may be harmed. In addition, we anticipate that Windows 10 will enable new post-license monetization opportunities beyond initial license revenues. Our failure to realize these opportunities to the extent we expect could have an adverse impact on our revenues.

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. These 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 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 in 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.

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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 global intellectual property rights and combating unlicensed copying and use of our software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. 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 consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. 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 and Lumia phones. 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 do so.

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

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

Security of Microsoft s information technology

Threats to IT security can take a variety of forms. Individual and groups of hackers, and sophisticated organizations including state-sponsored organizations or nation-states themselves, may take steps that pose threats to our customers and our IT. These actors may use a wide variety of methods, which may include developing and deploying malicious software to attack our products and services and gain access to our networks and datacenters, using social engineering techniques, or acting in a coordinated manner to launch distributed denial of service or other coordinated attacks. Cyber threats are constantly evolving, thereby increasing the difficulty of detecting and successfully defending against

them. Cyber threats can have cascading impacts that unfold with increasing speed

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across our internal networks and systems and those of our partners and customers. Breaches of our network or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, result in product development delays, compromise confidential or technical business information harming our competitive position, result in theft or misuse of our intellectual property or other assets, require us to allocate more resources to improved technologies, or otherwise adversely affect our business.

In addition, our internal IT environment continues to evolve. Often we are early adopters of new devices and technologies. We embrace new ways of sharing data and communicating internally and with partners and customers using methods such as social networking and other consumer-oriented technologies. Our business policies and internal security controls may not keep pace with these changes as new threats emerge.

Security of our products, services, devices, and customers data

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

To defend against security threats, both to our internal IT systems and those of our customers, we must continuously engineer more secure products and services, enhance security and reliability features, improve the deployment of software updates to address security vulnerabilities, develop mitigation technologies that help to secure customers from attacks even when software updates are not deployed, maintain the digital security infrastructure that protects the integrity of our network, products, and services, and provide customers security tools such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. If we fail to do these things well, actual or perceived security vulnerabilities in our products and services could harm our reputation and lead customers to reduce or delay future purchases of products or subscriptions to services, or to use competing products or services. Customers may also spend more on protecting their existing computer systems from attack, which could delay adoption of additional products or services. Customers may fail to update their systems, continue to run software or operating systems we no longer support, or may fail timely to install security patches. Any of these actions by customers could adversely affect our revenue. Actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to liability, there is no assurance these provisions will withstand legal challenges. Legislative or regulatory action in these areas may increase the costs to develop, implement, or secure our products and services.

Disclosure of personal data could cause liability and harm our reputation. As we continue to grow the number and scale of our cloud-based offerings, we store and process increasingly large amounts of personally identifiable information of our customers. The continued occurrence of high-profile data breaches provides evidence of an external environment increasingly hostile to information security. Despite our efforts to improve the security controls across our business groups and geographies, it is possible our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of customer data we or our vendors store and manage. Improper disclosure could harm our reputation, lead to legal exposure to customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data on-premises or, increasingly, in a cloud-based environment we host. Government authorities can sometimes require us to produce customer data in response to valid legal orders. In the U.S. and elsewhere, we advocate for transparency concerning these requests and appropriate limitations on government authority to compel disclosure. Despite our efforts to protect customer data, perceptions that the collection, use and retention of personal information is not satisfactorily protected could inhibit sales of our products or services, and could limit adoption of our cloud-based solutions by consumers, businesses, and government entities. Additional security measures we may take to address customer concerns, or constraints on our flexibility to determine where and how to operate datacenters in response to customer expectations or governmental rules or actions, may cause higher operating expenses.

We may have outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic, growth in services, and the complexity of our products and services demand more computing power. We spend substantial amounts to build, purchase, or lease datacenters

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and equipment and to upgrade our technology and network infrastructure to handle more traffic on our websites and in our datacenters. These demands continue to increase as we introduce new products and services and support the growth of existing services such as Bing, Exchange Online, Office 365, SharePoint Online, OneDrive, Skype, Xbox Live, Microsoft Azure, Outlook.com, Windows Stores, and Microsoft Account services. We are rapidly growing our business of providing a platform and back-end hosting for services provided by third parties to their end users. Maintaining, securing, and expanding this infrastructure is expensive and complex. It requires that we maintain an Internet connectivity infrastructure that is robust and reliable within competitive and regulatory constraints that continue to evolve. Inefficiencies or operational failures, including temporary or permanent loss of customer data or insufficient Internet connectivity, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

Government litigation and regulatory activity relating to competition rules may limit how we design and market our products. As a leading global software and device maker, we are closely scrutinized by government agencies under U.S. and foreign competition laws. An increasing number of governments are regulating competition law activities and this includes increased scrutiny in potentially large markets such as the European Union (EU), the U.S., and China. Some jurisdictions also allow competitors or consumers to assert claims of anti-competitive conduct. U.S. federal and state antitrust authorities have previously brought enforcement actions and continue to scrutinize our business.

The European Commission (the Commission) closely scrutinizes the design of high-volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. In 2004, the Commission ordered us to create new versions of our Windows operating system that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. In 2009, the Commission accepted a set of commitments offered by Microsoft to address the Commission s concerns relating to competition in web browsing software, including an undertaking to address Commission concerns relating to interoperability. The web browsing commitments expired in 2014. The remaining obligations may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our products, which could hamper sales of our products.

Our portfolio of first-party devices continues to grow; at the same time our OEM partners offer a large variety of devices on our platforms. As a result, increasingly we both cooperate and compete with our OEM partners, creating a risk that we fail to do so in compliance with competition rules. Regulatory scrutiny in this area may increase. Certain foreign governments, particularly in China and other countries in Asia, have advanced arguments under their competition laws that exert downward pressure on royalties for our intellectual property. Because these jurisdictions only recently implemented competition laws, their enforcement activities are unpredictable.

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

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

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

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

We are subject to a variety of ongoing commitments because of court or administrative orders, consent decrees, or other voluntary actions we have taken. If we fail to comply with these commitments, we may incur litigation costs and be subject to substantial fines or other remedial actions.

Our ability to realize anticipated Windows 10 post-sale monetization opportunities may be limited.

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Our global operations subject us to potential liability under anti-corruption, trade protection, and other laws and regulations. The Foreign Corrupt Practices Act and other anti-corruption laws and regulations (Anti-Corruption Laws) prohibit corrupt payments by our employees, vendors, or agents. From time to time, we receive inquiries from authorities in the U.S. and elsewhere and reports from employees and others about our business activities outside the U.S. and our compliance with Anti-Corruption Laws. While we devote substantial resources to our global compliance programs and have implemented policies, training, and internal controls designed to reduce the risk of corrupt payments, our employees, vendors, or agents may violate our policies. Our failure to comply with Anti-Corruption Laws could result in significant fines and penalties, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation. Geopolitical instability may lead to sanctions and impact our ability to do business in some geographies. Operations outside the U.S. may be affected by changes in trade protection laws, policies, and measures, sanctions, and other regulatory requirements affecting trade and investment. We may be subject to legal liability and reputational damage if we sell goods or services in violation of U.S. trade sanctions on countries such as Iran, North Korea, Cuba, Sudan, and Syria.

Other regulatory areas that may apply to our products and online services offerings include user privacy, telecommunications, data storage and protection, and online content. For example, regulators may take the position that our offerings such as Skype are covered by laws regulating telecommunications services. Applying these laws and regulations to our business is often unclear, subject to change over time, and sometimes may conflict from jurisdiction to jurisdiction. Additionally, these laws and governments approach to their enforcement, and our products and services, are continuing to evolve. Compliance with these types of regulation may involve significant costs or require changes in products or business practices that result in reduced revenue. Noncompliance could result in the imposition of penalties or orders we stop the alleged noncompliant activity.

Laws and regulations relating to the handling of personal data may impede the adoption of our services or result in increased costs, legal claims, or fines against us. The growth of our internet- and cloud-based services internationally relies increasingly on the movement of data across national boundaries. Legal requirements relating to the collection, storage, handling, and transfer of personal data continue to evolve. For example, in October 2015 the European Court of Justice (ECJ) invalidated the EU/U.S. safe harbor framework, in place since 2000, that enabled companies to transfer data from EU member states to the U.S. Although other legally-recognized methods to enable data transfers currently remain valid, the reasoning of the ECJ striking down the safe harbor framework could be used to challenge those methods in future complaints. There is a recognized need for a new regulatory safe harbor framework that will also support other methods of data transfer between the EU and U.S. Outcomes may include a new trans-Atlantic data transfer agreement, a new EU data protection directive, or a range of legal requirements adopted by individual EU member states, or no action at all. One or more of these outcomes may result in burdensome or inconsistent requirements affecting the location and movement of our customer and internal employee data as well as the management of that data. Compliance may require changes in services, business practices, or internal systems that result in increased costs, lower revenue, reduced efficiency, or greater difficulty in competing with foreign-based firms. Failure to comply with existing or new rules may result in significant penalties or orders to stop the alleged noncompliant activity.

Our business depends on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we cannot retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

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

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities in different jurisdictions. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes favorably more difficult.

Although we believe our tax estimates are

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reasonable, the final determination of tax audits and any related litigation in the jurisdictions where we are subject to taxation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our consolidated financial statements in the period or periods in which that determination is made.

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

Our hardware and software products may experience quality or supply problems. Our vertically-integrated hardware products such as Xbox consoles, Surface devices, phones, and other devices we design, manufacture, and market are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or address such issues through design, testing, or warranty repairs. We acquire some device components from sole suppliers. Our competitors use some of the same suppliers and their demand for hardware components can affect the capacity available to us. If a component from a sole-source supplier is delayed or becomes unavailable, whether because of supplier capacity constraint or industry shortages, we may not obtain timely replacement supplies, resulting in reduced sales. Component shortages, excess or obsolete inventory, or price reductions resulting in inventory adjustments may increase our cost of revenue. Xbox consoles, Surface devices, phones, and other hardware are assembled in Asia and other geographies that may be subject to disruptions in the supply chain, resulting in shortages that would affect our revenue and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

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

Our global business exposes us to operational and economic risks. Our customers are located in over 200 countries and a significant part of our revenue comes from international sales. The global nature of our business creates operational and economic risks. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents several risks, including deterioration of social, political, labor, or economic conditions in a country or region, and difficulties in staffing and managing foreign operations. Although we hedge a portion of our international currency exposure, significant fluctuations in foreign exchange rates between the U.S. dollar and foreign currencies may adversely affect our revenue. Competitive or regulatory pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the U.S. and other countries.

Catastrophic events or geopolitical conditions may disrupt our business. A disruption or failure of our systems or operations because of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other essential business operations are in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are seismically active regions. A catastrophic event that results in the destruction or disruption of any of our critical business or IT systems could harm our ability to conduct normal business operations. Providing our customers with more services and solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged service outages on our operating results.

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

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Adverse economic or market conditions may harm our business. Worsening economic conditions, including inflation, recession, or other changes in economic conditions, may cause lower IT spending and adversely affect our revenue. If demand for PCs, servers, and other computing devices declines, or consumer or business spending for those products declines, our revenue will be adversely affected. Substantial revenue comes from our U.S. government contracts. An extended federal government shutdown resulting from failing to pass budget appropriations, adopt continuing funding resolutions or raise the debt ceiling, and other budgetary decisions limiting or delaying federal government spending, could reduce government IT spending on our products and services and adversely affect our revenue.

Our product distribution system relies on an extensive partner and retail network. OEMs building devices that run our software have also been a significant means of distribution. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, OEM, or retailer, could cause sales channel disruption.

Challenging economic conditions also may impair the ability of our customers to pay for products and services they have purchased. As a result, allowances for doubtful accounts and write-offs of accounts receivable may increase.

We maintain an investment portfolio of various holdings, types, and maturities. These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that affect global financial markets. A significant part of our investment portfolio comprises U.S. government securities. If global credit and equity markets decline for long periods, or if there is a downgrade of the U.S. government credit rating due to an actual or threatened default on government debt, our investment portfolio may be adversely affected and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely affect our financial results.

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

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

(c) STOCK REPURCHASES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs
				(in millions)
October 1, 2015 October 31, 2015	3,500,000	$ 53.47	3,500,000	$ 17,696
November 1, 2015 November 30, 2015	30,592,734	$ 53.86	30,592,734	$ 16,048
December 1, 2015 December 31, 2015	31,882,580	$ 55.37	31,882,580	$ 14,283
	65,975,314		65,975,314	

During the three months ended December 31, 2015, we repurchased 66 million shares of our common stock for $3.6 billion under a $40.0 billion share repurchase plan approved by our Board of Directors on September 16, 2013. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. While the program has no expiration date, we intend to complete it by December 31, 2016. As of December 31, 2015, $14.3 billion remained of the $40.0 billion share repurchase program. All repurchases were made using cash resources. Our stock repurchases may occur through open market purchases or pursuant to a

Rule 10b5-1 trading plan.

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

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ITEM 6. EXHIBITS

4.13	Tenth Supplemental Indenture for 1.300% Notes due 2018, 2.000% Notes due 2020, 2.650% Notes due 2022, 3.125% Notes due 2025, 4.200% Notes due 2035, 4.450% Notes due 2045, and 4.750% Notes due 2055, dated as of November 3, 2015, between Microsoft Corporation and U.S. Bank, National Association, as trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as trustee (incorporated by reference to Current Report on Form 8-K filed November 3, 2015)
15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

* *Furnished, not filed*

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

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SIGNATURE

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

MICROSOFT CORPORATION

/s/ FRANK H. BROD
Frank H. Brod
Corporate Vice President, Finance and Administration;

Chief Accounting Officer (Duly Authorized Officer)
January 28, 2016