MICROSOFT CORP
Form 10-Q
January 26, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended December 31, 2016

OR

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

Commission File Number: 001-37845

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

(425) 882-8080

(Registrant's telephone number, including area code)

None

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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		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

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 20, 2017
Common Stock, $0.00000625 par value per share	7,727,529,820 shares

MICROSOFT CORPORATION

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For the Quarter Ended December 31, 2016

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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,	
	2016	2015	2016	2015
Revenue:				
Product	$ 16,537	$17,974	$ 30,030	$ 33,193
Service and other	7,553	5,822	14,513	10,982
Total revenue	24,090	23,796	44,543	44,175
Cost of revenue:				
Product	5,378	6,268	8,959	10,303
Service and other	4,523	3,604	8,786	6,776
Total cost of revenue	9,901	9,872	17,745	17,079
Gross margin	14,189	13,924	26,798	27,096
Research and development	3,062	2,900	6,168	5,862
Sales and marketing	4,071	3,960	7,304	7,293
General and administrative	879	1,038	1,924	2,122
Operating income	6,177	6,026	11,402	11,819
Other income (expense), net	186	(171)	286	(451)
Income before income taxes	6,363	5,855	11,688	11,368
Provision for income taxes	1,163	837	1,798	1,448
Net income	$5,200	$5,018	$9,890	$9,920

Earnings per share:				
Basic	$0.67	$0.63	$1.27	$1.24
Diluted	$0.66	$0.62	$1.26	$1.23
Weighted average shares outstanding:				
Basic	7,755	7,964	7,772	7,980
Diluted	7,830	8,051	7,853	8,068
Cash dividends declared per common share	$0.39	$0.36	$0.78	$0.72

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Net income	$ 5,200	$ 5,018	$ 9,890	$ 9,920
Other comprehensive income (loss):				
Net unrealized gains (losses) on derivatives (net of tax effects of $0, $5, $(2), and $28)	280	(49)	243	8
Net unrealized gains (losses) on investments (net of tax effects of $(535), $86, $(491), and $(222))	(994)	160	(911)	(411)
Translation adjustments and other (net of tax effects of $0, $(9), $7, and $(21))	(455)	(76)	(357)	(346)
Other comprehensive income (loss)	(1,169)	35	(1,025)	(749)
Comprehensive income	$ 4,031	$ 5,053	$ 8,865	$ 9,171

See accompanying notes.

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BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2016	June 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	$8,468	$6,510
Short-term investments (including securities loaned of $1,230 and $204)	114,313	106,730
Total cash, cash equivalents, and short-term investments	122,781	113,240
Accounts receivable, net of allowance for doubtful accounts of $340 and $426	14,343	18,277
Inventories	1,961	2,251
Other	5,864	5,892
Total current assets	144,949	139,660
Property and equipment, net of accumulated depreciation of $21,888 and $19,800	21,379	18,356
Equity and other investments	8,912	10,431
Goodwill	34,524	17,872
Intangible assets, net	11,001	3,733
Other long-term assets	3,845	3,416
Total assets	$ 224,610	$ 193,468
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$6,580	$6,898
Short-term debt	25,065	12,904
Current portion of long-term debt	599	0
Accrued compensation	3,982	5,264
Income taxes	508	580
Short-term unearned revenue	26,085	27,468
Securities lending payable	1,280	294
Other	6,688	5,949
Total current liabilities	70,787	59,357

Long-term debt	59,306	40,557
Long-term unearned revenue	8,595	6,441
Deferred income taxes	1,133	1,476
Other long-term liabilities	15,980	13,640
Total liabilities	155,801	121,471
Commitments and contingencies		
Stockholders’ equity:		
Common stock and paid-in capital—shares authorized 24,000; outstanding 7,730 and 7,808	68,177	68,178
Retained earnings	120	2,282
Accumulated other comprehensive income	512	1,537
Total stockholders’ equity	68,809	71,997
Total liabilities and stockholders’ equity	$224,610	$193,468

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Operations				
Net income	$5,200	$5,018	$9,890	$9,920
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	2,166	1,544	3,982	3,005
Stock-based compensation expense	767	658	1,470	1,332
Net recognized losses (gains) on investments and derivatives	(652)	50	(963)	151
Deferred income taxes	(587)	(247)	(572)	(174)
Deferral of unearned revenue	14,141	12,570	26,724	22,993
Recognition of unearned revenue	(13,645)	(11,929)	(26,549)	(23,284)
Changes in operating assets and liabilities:				
Accounts receivable	(2,711)	(3,118)	4,463	3,258
Inventories	1,132	1,104	265	167
Other current assets	1,309	(932)	343	(1,494)
Other long-term assets	(243)	56	(272)	51
Accounts payable	99	369	(344)	234
Other current liabilities	(1,529)	105	(1,890)	(1,919)
Other long-term liabilities	846	370	1,295	254
Net cash from operations	6,293	5,618	17,842	14,494
Financing				
Repayments of short-term debt, maturities of 90 days or less, net	(3,755)	(7,031)	(7,145)	(2,141)
Proceeds from issuance of debt	17,069	13,128	42,046	13,249
Repayments of debt	(4,118)	(121)	(4,343)	(1,871)
Common stock issued	131	117	372	336
Common stock repurchased	(3,599)	(3,678)	(7,961)	(8,435)
Common stock cash dividends paid	(3,024)	(2,868)	(5,824)	(5,343)
Other	312	(65)	200	(243)
Net cash from (used in) financing	3,016	(518)	17,345	(4,448)
Investing				

Additions to property and equipment	(1,988)	(2,024)	(4,151)	(3,380)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(24,760)	(381)	(24,784)	(771)
Purchases of investments	(46,775)	(34,750)	(103,956)	(72,320)
Maturities of investments	8,715	5,351	17,374	11,037
Sales of investments	48,987	28,191	81,310	56,693
Securities lending payable	1,070	285	986	347
Net cash used in investing	(14,751)	(3,328)	(33,221)	(8,394)
Effect of foreign exchange rates on cash and cash equivalents	(18)	(18)	(8)	(62)
Net change in cash and cash equivalents	(5,460)	1,754	1,958	1,590
Cash and cash equivalents, beginning of period	13,928	5,431	6,510	5,595
Cash and cash equivalents, end of period	$8,468	$7,185	$8,468	$7,185

See accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Common stock and paid-in capital				
Balance, beginning of period	$67,747	$67,811	$68,178	$68,465
Common stock issued	131	117	372	336
Common stock repurchased	(561)	(609)	(1,935)	(2,157)
Stock-based compensation expense	767	658	1,470	1,332
Other, net	93	0	92	1
Balance, end of period	68,177	67,977	68,177	67,977
Retained earnings				
Balance, beginning of period	944	7,896	2,282	9,096
Net income	5,200	5,018	9,890	9,920
Common stock cash dividends	(3,003)	(2,846)	(6,028)	(5,708)
Common stock repurchased	(3,021)	(3,038)	(6,024)	(6,278)
Balance, end of period	120	7,030	120	7,030
Accumulated other comprehensive income				
Balance, beginning of period	1,681	1,738	1,537	2,522
Other comprehensive income (loss)	(1,169)	35	(1,025)	(749)
Balance, end of period	512	1,773	512	1,773
Total stockholders' equity	$ 68,809	$ 76,780	$ 68,809	$ 76,780

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 accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair presentation of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2016 Form 10-K filed with the U.S. Securities and Exchange Commission on July 28, 2016.

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.

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 intangible 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 and volume of demand for 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 on our consolidated financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

Product Revenue and Service and Other Revenue

Product revenue includes sales from operating systems; cross-device productivity applications; server applications; business solution applications; desktop and server management tools; software development tools; video games;

hardware such as PCs, tablets, gaming and entertainment consoles, phones, other intelligent devices, and related accessories; and training and certification of computer system integrators and developers.

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

Recent Accounting Guidance Not Yet Adopted

Financial Instruments – Credit Losses

In June 2016, the Financial Accounting Standards Board (“FASB”) issued a new standard to replace the incurred loss impairment methodology in current U.S. GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For trade and other receivables, loans, and other financial instruments, we will be required to use a forward-looking expected loss model rather than the incurred loss model for recognizing credit losses which reflects losses that are probable. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. The new standard will be effective for us beginning July 1, 2020, with early adoption permitted beginning July 1, 2019. Application of the amendments is through a cumulative-effect adjustment to retained earnings as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements.

Leases

In February 2016, the FASB issued a new standard related to leases to increase transparency and comparability among organizations by requiring the recognition of lease assets and lease liabilities on the balance sheet. Most prominent among the amendments is the recognition of assets and liabilities by lessees for those leases classified as operating leases under previous U.S. GAAP. Under the new standard, disclosures are required to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We will be required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach.

The new standard will be effective for us beginning July 1, 2019, with early adoption permitted. We currently anticipate early adoption of the new standard effective July 1, 2017 in conjunction with our adoption of the new revenue standard. Our ability to early adopt is dependent on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior period financial statements. We remain on schedule and have implemented specific system functionality to enable the accounting transition.

We anticipate this standard will have a material impact on our consolidated balance sheets. However, we do not believe adoption will have a material impact on our consolidated income statements. Due to the recent acquisition of LinkedIn Corporation (“LinkedIn”), we are still assessing the qualitative and quantitative impacts of the leases assumed on our consolidated balance sheets. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting for office space, retail space, and datacenter operating leases. We expect our accounting for capital leases related to office space and datacenters will remain substantially unchanged under the new standard.

Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

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 sheets as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements.

Revenue from Contracts with Customers

In May 2014, the FASB issued a new standard related to revenue recognition. Under the new standard, revenue is recognized when a customer obtains control of promised goods or services and is recognized 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 FASB recently issued several amendments to the standard, including clarifications on disclosure of prior-period performance obligations and remaining performance obligations.

The guidance permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the cumulative catch-up transition method). We currently anticipate adopting the standard using the full retrospective method to restate each prior reporting period presented.

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 currently anticipate early adoption of the new standard effective July 1, 2017. While our ability to early adopt using the full retrospective method is dependent on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior

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period financial statements, we remain on schedule and have implemented key system functionality to enable restated financial information. Our progress includes nearing completion of retrospectively adjusted financial information for fiscal year 2016.

We anticipate this standard will have a material impact on our consolidated financial statements, and continue to make progress in assessing all potential impacts of the standard, including any impacts from recently issued amendments. We have reached conclusions on all key accounting assessments related to the new standard. However, we are still assessing impacts from guidance issued by the FASB Transition Resource Group as part of their November 2016 meeting. We will continue to monitor and assess the impact of changes to the standard and interpretations as they become available. We have also started our assessment to determine the revenue recognition impact of our recent acquisition of LinkedIn. The most significant impact of the standard relates to our accounting for software license revenue. Specifically, under the new standard we expect to recognize Windows 10 revenue predominantly at the time of billing rather than ratably over the life of the related device. We expect to recognize license revenue at the time of contract execution rather than over the subscription period from certain multi-year commercial software subscriptions that include both software licenses and Software Assurance. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard will be dependent on contract-specific terms, and may vary in some instances from recognition at the time of billing. We expect revenue recognition related to our hardware, cloud offerings including Office 365, and professional services to remain substantially unchanged.

We continue to believe that the net change in Windows 10 revenue from period to period is indicative of the net change in revenue we expect from the adoption of the new standard.

NOTE 2 — EARNINGS PER SHARE

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

The components of basic and diluted EPS were as follows:

	Three Months Ended		Six Months Ended	
(In millions, except earnings per share)	December 31,		December 31,	
	2016	2015	2016	2015
Net income available for common shareholders (A)	$ 5,200	$ 5,018	$ 9,890	$ 9,920

Weighted average outstanding shares of common stock (B)	7,755	7,964	7,772	7,980
Dilutive effect of stock-based awards	75	87	81	88
Common stock and common stock equivalents (C)	7,830	8,051	7,853	8,068
Earnings Per Share				
Basic (A/B)	$ 0.67	$ 0.63	$ 1.27	$ 1.24
Diluted (A/C)	$ 0.66	$ 0.62	$ 1.26	$ 1.23

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,	
	2016	2015	2016	2015
Dividends and interest income	$ 311	$ 200	$ 604	$ 399
Interest expense	(521)	(309)	(958)	(558)
Net recognized gains on investments	698	106	1,103	108
Net losses on derivatives	(46)	(156)	(140)	(259)
Net gains (losses) on foreign currency remeasurements	(82)	2	(134)	(34)
Other	(174)	(14)	(189)	(107)
Total	$ 186	$ (171)	$ 286	$ (451)

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,	
	2016	2015	2016	2015
Other-than-temporary impairments of investments	$ (21)	$ (127)	$ (39)	$ (162)
Realized gains from sales of available-for-sale securities	851	351	1,334	458
Realized losses from sales of available-for-sale securities	(132)	(118)	(192)	(188)
Total	$ 698	$ 106	$ 1,103	$ 108

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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 Equivalents	Short-term Investments	Equity and Other Investments
December 31, 2016							
Cash	$4,037	$ 0	$ 0	$4,037	$ 4,037	$ 0	$ 0
Mutual funds	2,363	0	0	2,363	1,961	402	0
Commercial paper	177	0	0	177	77	100	0
Certificates of deposit	1,284	0	0	1,284	1,098	186	0
U.S. government and agency securities	100,128	27	(415)	99,740	1,052	98,688	0
Foreign government bonds	4,747	3	(29)	4,721	243	4,478	0
Mortgage- and asset-backed securities	4,361	12	(7)	4,366	0	4,366	0
Corporate notes and bonds	5,736	64	(26)	5,774	0	5,774	0
Municipal securities	283	39	0	322	0	322	0
Common and preferred stock	4,864	3,685	(160)	8,389	0	0	8,389
Other investments	494	0	0	494	0	(3)	497
Total	$ 128,474	$ 3,830	$ (637)	$ 131,667	$ 8,468	$ 114,313	$ 8,886

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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, 2016							
Cash	$3,501	$0	$0	$3,501	$3,501	$0	$0
Mutual funds	1,012	0	0	1,012	1,012	0	0
Commercial paper	298	0	0	298	298	0	0
Certificates of deposit	1,000	0	0	1,000	868	132	0
U.S. government and agency securities	89,970	245	(11)	90,204	100	90,104	0
Foreign government bonds	5,502	10	(18)	5,494	731	4,763	0
Mortgage- and asset-backed securities	4,789	21	(2)	4,808	0	4,808	0
Corporate notes and bonds	6,509	110	(35)	6,584	0	6,584	0
Municipal securities	285	57	0	342	0	342	0
Common and preferred stock	5,597	4,452	(236)	9,813	0	0	9,813
Other investments	590	0	0	590	0	(3)	593
Total	$ 119,053	$ 4,895	$ (302)	$ 123,646	$ 6,510	$ 106,730	$ 10,406

As of December 31, 2016 and June 30, 2016, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $815 million and $767 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 sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. As of December 31, 2016 and June 30, 2016, the collateral received under agreements for loaned securities totaled $1.3 billion and $294 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 Unrealized

(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Losses
December 31, 2016						
U.S. government and agency securities	$86,391	$ (403)	$375	$ (12)	$86,766	$ (415)
Foreign government bonds	3,721	(10)	35	(19)	3,756	(29)
Mortgage- and asset-backed securities	887	(6)	199	(1)	1,086	(7)
Corporate notes and bonds	1,100	(14)	408	(12)	1,508	(26)
Common and preferred stock	677	(71)	407	(89)	1,084	(160)
Total	$ 92,776	$ (504)	$ 1,424	$ (133)	$ 94,200	$ (637)

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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, 2016						
U.S. government and agency securities	$5,816	$ (3)	$432	$ (8)	$6,248	$ (11)
Foreign government bonds	3,452	(3)	35	(15)	3,487	(18)
Mortgage- and asset-backed securities	844	(1)	322	(1)	1,166	(2)
Corporate notes and bonds	1,180	(11)	788	(24)	1,968	(35)
Common and preferred stock	896	(147)	390	(89)	1,286	(236)
Total	$ 12,188	$ (165)	$ 1,967	$ (137)	$ 14,155	$ (302)

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, 2016		
Due in one year or less	$16,027	$16,026
Due after one year through five years	94,925	94,669
Due after five years through 10 years	4,470	4,402
Due after 10 years	1,294	1,287
Total	$ 116,716	$ 116,384

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, 2016 and June 30, 2016, the total notional amounts of these foreign exchange contracts sold were $6.7 billion and $8.4 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, 2016 and June 30, 2016, the total notional amounts of these foreign exchange contracts sold were $4.5 billion and $5.3 billion, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures. As of December 31, 2016, the total notional amounts of these foreign exchange contracts purchased and sold were $7.8 billion and $8.8 billion, respectively. As of June 30, 2016, the total notional amounts of these foreign exchange contracts purchased and sold were $12.0 billion and $11.7 billion, respectively.

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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, 2016, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.2 billion and $1.8 billion, respectively, of which $567 million and $764 million, respectively, were designated as hedging instruments. As of June 30, 2016, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.3 billion and $2.2 billion, respectively, of which $737 million and $986 million, 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, 2016, the total notional amounts of fixed-interest rate contracts purchased and sold were $453 million and $520 million, respectively. As of June 30, 2016, the total notional amounts of fixed-interest rate contracts purchased and sold were $328 million and $2.4 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, 2016 and June 30, 2016, the total notional derivative amounts of mortgage contracts purchased were $570 million and $548 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, 2016, the total notional amounts of credit contracts purchased and sold were $359 million and $144 million, respectively. As of June 30, 2016, the total notional amounts of credit contracts purchased and sold were $440 million and $273 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, 2016, the total notional amounts of commodity contracts purchased and sold were $542 million and $157 million, respectively. As of June 30, 2016, the total notional amounts of commodity contracts purchased and sold were $631 million and $162 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, 2016, 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, 2016				June 30, 2016			
	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	$23	$229	$ 0	$ (238)	$33	$156	$ 0	$ (296)
Equity contracts	20	0	0	(4)	23	0	0	(16)
Interest rate contracts	5	0	0	(5)	10	0	0	(25)
Credit contracts	6	0	0	(3)	6	0	0	(5)
Commodity contracts	1	0	0	0	0	0	0	0
Total	$55	$229	$ 0	$ (250)	$72	$156	$ 0	$ (342)
Designated Hedge Derivatives								
Foreign exchange contracts	$293	$543	$ 0	$ 0	$1	$392	$ 0	$ (263)
Equity contracts	0	0	1	(26)	0	0	18	(25)
Total	$293	$543	$ 1	$ (26)	$1	$392	$ 18	$ (288)
Total gross amounts of derivatives	$348	$772	$ 1	$ (276)	$73	$548	$ 18	$ (630)
Gross derivatives either offset or subject to an enforceable master netting agreement	$348	$772	$ 1	$ (275)	$69	$548	$ 18	$ (630)

Gross amounts of derivatives offset on the balance sheet	(2)	(227)	(25)	251	(74)	(302)	(25)	398
Net amounts presented on the balance sheet	346	545	(24)	(24)	(5)	246	(7)	(232)
Gross amounts of derivatives not offset on the balance sheet	0	0	0	(1)	0	0	0	0
Cash collateral received	0	0	0	(548)	0	0	0	(250)
Net amount	$346	$545	$ (24)	$ (573)	$(5)	$246	$ (7)	$ (482)

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:

	Three Months Ended		Six Months Ended	
(In millions)	December 31,		December 31,	
	2016	2015	2016	2015
Foreign Exchange Contracts				
Derivatives	$ 685	$ 48	$ 637	$ (33)
Hedged items	(674)	(41)	(606)	50
Total amount of ineffectiveness	$ 11	$ 7	$ 31	$ 17
Equity Contracts				
Derivatives	$ (7)	$ (59)	$ (17)	$ (92)
Hedged items	7	59	17	92
Total amount of ineffectiveness	$ 0	$ 0	$ 0	$ 0
Amount of equity contracts excluded from effectiveness assessment	$ (1)	$ (15)	$ (4)	$ 4

Cash Flow Hedge Gains (Losses)

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

	Three Months Ended		Six Months Ended	
(In millions)	December 31,		December 31,	
	2016	2015	2016	2015

Effective Portion

Gains recognized in other comprehensive income (net of tax effects of $3, $15, $4, and $43)	$ 449	$ 122	$ 484	$ 283
Gains reclassified from accumulated other comprehensive income into revenue	172	181	247	290

Amount Excluded from Effectiveness Assessment and Ineffective Portion

Losses recognized in other income (expense), net	(84)	(72)	(154)	(154)

We estimate that $490 million of net derivative gains included in AOCI at December 31, 2016 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, 2016.

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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,	
	2016	2015	2016	2015
Foreign exchange contracts	$ 26	$ (134)	$ (5)	$ (75)
Equity contracts	(25)	(30)	(42)	4
Interest-rate contracts	(10)	9	(6)	8
Credit contracts	2	2	4	(3)
Commodity contracts	22	(52)	0	(136)
Total	$ 15	$ (205)	$ (49)	$ (202)

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 and liabilities primarily comprise investments in common and preferred stock, and goodwill and intangible assets, when they are recorded at fair value due to an impairment charge. Unobservable inputs used in the models are significant to the fair values of the assets and liabilities.

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

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Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting (a)	Net Fair Value
December 31, 2016						
Assets						
Mutual funds	$2,363	$0	$0	$2,363	$0	$2,363
Commercial paper	0	177	0	177	0	177
Certificates of deposit	0	1,284	0	1,284	0	1,284
U.S. government and agency securities	93,744	5,996	0	99,740	0	99,740
Foreign government bonds	12	4,398	0	4,410	0	4,410
Mortgage- and asset-backed securities	0	4,366	0	4,366	0	4,366
Corporate notes and bonds	0	5,736	1	5,737	0	5,737
Municipal securities	0	322	0	322	0	322
Common and preferred stock	5,750	1,833	18	7,601	0	7,601
Derivatives	5	1,116	0	1,121	(254)	867
Total	$ 101,874	$ 25,228	$ 19	$ 127,121	$ (254)	$ 126,867
Liabilities						
Derivatives and other	$1	$275	$23	$299	$(251)	$48

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting (a)	Net Fair Value
June 30, 2016						
Assets						

Mutual funds	$1,012	$0	$0	$1,012	$0	$1,012
Commercial paper	0	298	0	298	0	298
Certificates of deposit	0	1,000	0	1,000	0	1,000
U.S. government and agency securities	86,492	3,707	0	90,199	0	90,199
Foreign government bonds	10	5,705	0	5,715	0	5,715
Mortgage- and asset-backed securities	0	4,803	0	4,803	0	4,803
Corporate notes and bonds	0	6,361	1	6,362	0	6,362
Municipal securities	0	342	0	342	0	342
Common and preferred stock	6,918	2,114	18	9,050	0	9,050
Derivatives	6	633	0	639	(401)	238
Total	$ 94,438	$ 24,963	$ 19	$ 119,420	$ (401)	$ 119,019
Liabilities						
Derivatives and other	$17	$613	$0	$630	$(398)	$232

(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, 2016	June 30, 2016
Net fair value of assets measured at fair value on a recurring basis	$126,867	$119,019
Cash	4,037	3,501
Common and preferred stock measured at fair value on a nonrecurring basis	815	767
Other investments measured at fair value on a nonrecurring basis	497	593
Less derivative net assets classified as other current assets	(545)	(246)
Other	(4)	12
Recorded basis of investment components	$ 131,667	$ 123,646

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

During the three and six months ended December 31, 2016 and 2015, 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, 2016	June 30, 2016
Raw materials	$ 363	$612
Work in process	98	158
Finished goods	1,500	1,481

Total	$ 1,961	$ 2,251

NOTE 8 — BUSINESS COMBINATIONS

On December 8, 2016, we completed our acquisition of all of the issued and outstanding shares of LinkedIn, the world's largest professional network on the Internet, for a preliminary total purchase price of $27.0 billion. The purchase price primarily consisted of cash of $26.4 billion. The acquisition is expected to accelerate the growth of LinkedIn, Office 365, and Dynamics 365. The financial results of LinkedIn have been included in our consolidated financial statements since the date of the acquisition.

The purchase price allocation as of the date of the acquisition was based on a preliminary valuation and is subject to revision as more detailed analyses are completed and additional information about the fair value of assets acquired and liabilities assumed becomes available.

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The major classes of assets and liabilities to which we have preliminarily allocated the purchase price were as follows:

(In millions)	
Cash and cash equivalents	$1,328
Short-term investments	2,110
Other current assets	697
Property and equipment	1,565
Intangible assets	7,867
Goodwill [a]	16,813
Short-term debt [b]	(1,323)
Other current liabilities	(1,120)
Deferred income taxes	(808)
Other	(132)
Total purchase price	$ 26,997

(a) Goodwill was assigned to our Productivity and Business Processes segment. The goodwill was primarily attributed to increased synergies that are expected to be achieved from the integration of LinkedIn. None of the goodwill is expected to be deductible for income tax purposes.

(b) Convertible senior notes issued by LinkedIn on November 12, 2014, substantially all of which were redeemed prior to December 31, 2016. The remaining $18 million of notes are not redeemable and are included in long-term debt on our consolidated balance sheets. See Note 11 – Debt for further information.

Following are the details of the purchase price allocated to the intangible assets acquired:

(In millions)	Amount	Weighted Average Life
Technology-based	$2,109	3 years
Contract-based	23	5 years
Customer-related	3,587	7 years
Marketing-related (trade names)	2,148	20 years
Fair value of intangible assets acquired	$ 7,867	9 years

Our consolidated income statements for both the three and six months ended December 31, 2016 include revenue and operating loss of $228 million and $201 million, respectively, attributable to LinkedIn since the date of acquisition.

Following are the supplemental consolidated results of Microsoft Corporation on an unaudited pro forma basis, as if the acquisition had been consummated on July 1, 2015:

(In millions, except earnings per share)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Revenue	$ 24,866	$ 24,629	$ 46,271	$ 45,739
Net income	$5,010	$4,685	$9,494	$ 9,150
Diluted earnings per share	$0.64	$0.58	$1.21	$ 1.14

These pro forma results were based on estimates and assumptions, which we believe are reasonable. They are not the results that would have been realized had we been a combined company during the periods presented and are not necessarily indicative of our consolidated results of operations in future periods. The pro forma results include adjustments related to purchase accounting, primarily amortization of intangible assets. Acquisition costs and other non-recurring charges incurred were immaterial, and are included in the earliest period presented.

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NOTE 9 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30, 2016	Acquisitions		Other	December 31, 2016
Productivity and Business Processes	$6,678	$ 16,816	(a)	$(38)	$ 23,456
Intelligent Cloud	5,467	0		1	5,468
More Personal Computing	5,727	14		(141)	5,600
Total	$ 17,872	$ 16,830		$ (178)	$ 34,524

(a) Includes goodwill related to LinkedIn and other acquisitions. See Note 8 – Business Combinations for further information.

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

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

NOTE 10 — INTANGIBLE ASSETS

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

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
	December 31, 2016			June 30, 2016		

Technology-based [(a)]	$7,619	$ (3,604)	$4,015	$5,970	$ (3,648)	$2,322
Marketing-related	3,983	(691)	3,292	1,869	(616)	1,253
Contract-based	801	(709)	92	796	(718)	78
Customer-related	4,023	(421)	3,602	465	(385)	80
Total	$ 16,426 [(b)]	$ (5,425)	$ 11,001	$ 9,100	$ (5,367)	$ 3,733

(a) Technology-based intangible assets included $87 million and $115 million of net carrying amount of software to be sold, leased, or otherwise marketed as of December 31, 2016 and June 30, 2016, respectively.

(b) Includes intangible assets related to LinkedIn and other additions. See Note 8 – Business Combinations for further information.

Intangible assets amortization expense was $315 million and $529 million for the three and six months ended December 31, 2016, respectively, and $249 million and $491 million for the three and six months ended December 31, 2015, respectively. Amortization of capitalized software was $14 million and $28 million for the three and six months ended December 31, 2016, respectively, and $18 million and $36 million for the three and six months ended December 31, 2015, respectively.

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The following table outlines the estimated future amortization expense related to intangible assets held as of December 31, 2016:

(In millions)	
Year Ending June 30,	
2017 (excluding the six months ended December 31, 2016)	$ 1,103
2018	2,167
2019	1,688
2020	1,168
2021	978
Thereafter	3,897
Total	$ 11,001

NOTE 11 — DEBT

Short-term Debt

As of December 31, 2016, we had $25.1 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.78% and maturities ranging from 43 days to 266 days. As of June 30, 2016, we had $12.9 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.43% and maturities ranging from 1 day to 99 days. The estimated fair value of this commercial paper approximates its carrying value.

In November 2016, we entered into a $5.0 billion credit facility which replaced our $5.0 billion credit facility that expired on November 1, 2016. We currently have two $5.0 billion credit facilities that expire on October 31, 2017 and November 14, 2018, respectively. These credit facilities serve as a back-up for our commercial paper program. As of December 31, 2016, 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, 2016, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $59.9 billion and $60.8 billion, respectively. As of June 30, 2016, the total carrying value and estimated fair value of our long-term debt were $40.6 billion and $44.0 billion, respectively. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of December 31, 2016 and June 30, 2016:

Due Date	Face Value December 31, 2016	Face Value June 30, 2016	Stated Interest Rate	Effective Interest Rate
	(In millions)			
Notes				
November 15, 2017	600	600	0.875%	1.084%
May 1, 2018	450	450	1.000%	1.106%
November 3, 2018	1,750	1,750	1.300%	1.396%
December 6, 2018	1,250	1,250	1.625%	1.824%
June 1, 2019	1,000	1,000	4.200%	4.379%
August 8, 2019 (a)	2,500	*	1.100%	1.203%
November 1, 2019 (c)	18	*	0.500%	0.500%
February 12, 2020	1,500	1,500	1.850%	1.935%
October 1, 2020	1,000	1,000	3.000%	3.137%
November 3, 2020	2,250	2,250	2.000%	2.093%
February 8, 2021	500	500	4.000%	4.082%
August 8, 2021 (a)	2,750	*	1.550%	1.642%
December 6, 2021 (b)	1,846	1,944	2.125%	2.233%
February 12, 2022	1,500	1,500	2.375%	2.466%
November 3, 2022	1,000	1,000	2.650%	2.717%
November 15, 2022	750	750	2.125%	2.239%
May 1, 2023	1,000	1,000	2.375%	2.465%
August 8, 2023 (a)	1,500	*	2.000%	2.101%
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	3,000	3,000	3.125%	3.176%
August 8, 2026 (a)	4,000	*	2.400%	2.464%
December 6, 2028 (b)	1,846	1,944	3.125%	3.218%
May 2, 2033 (b)	580	611	2.625%	2.690%
February 12, 2035	1,500	1,500	3.500%	3.604%
November 3, 2035	1,000	1,000	4.200%	4.260%
August 8, 2036 (a)	2,250	*	3.450%	3.510%
June 1, 2039	750	750	5.200%	5.240%
October 1, 2040	1,000	1,000	4.500%	4.567%
February 8, 2041	1,000	1,000	5.300%	5.361%

November 15, 2042	900	900	3.500%	3.571%
May 1, 2043	500	500	3.750%	3.829%
December 15, 2043	500	500	4.875%	4.918%
February 12, 2045	1,750	1,750	3.750%	3.800%
November 3, 2045	3,000	3,000	4.450%	4.492%
August 8, 2046 (a)	4,500	*	3.700%	3.743%
February 12, 2055	2,250	2,250	4.000%	4.063%
November 3, 2055	1,000	1,000	4.750%	4.782%
August 8, 2056 (a)	2,250	*	3.950%	4.033%
Total	$ 60,490	$ 40,949		

(a) In August 2016, we issued $19.8 billion of debt securities.
(b) Euro-denominated debt securities.
(c) Remaining notes that were acquired as part of the LinkedIn acquisition. See Note 8 – Business combinations for further information.
* 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. Effective July 1, 2016, we retrospectively adopted accounting guidance that requires debt issuance costs to be recorded as a deduction from the carrying amount of the debt liability, consistent with debt discounts.

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As of December 31, 2016 and June 30, 2016, the combined aggregate unamortized discount and debt issuance costs associated with our long-term debt, including the current portion, were $585 million and $392 million, respectively.

NOTE 12 — INCOME TAXES

Our effective tax rate for the three months ended December 31, 2016 and 2015 was 18% and 14%, respectively, and our effective tax rate for the six months ended December 31, 2016 and 2015 was 15% and 13%, 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 higher 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. The prior year's second quarter effective tax rate also included a tax benefit related to the retroactive reinstatement of the U.S. research and development tax credit. The current year-to-date effective tax rate was higher 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.

Tax contingencies and other income tax liabilities were $13.3 billion and $11.8 billion as of December 31, 2016 and June 30, 2016, respectively, and are included in other long-term liabilities. This increase relates primarily to current period intercompany transfer pricing and foreign tax credits.

While we settled a portion of the Internal Revenue Service ("IRS") audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and settled a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. We also continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of December 31, 2016, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2016, 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 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 eliminated approximately 7,400 positions in fiscal year 2016.

In fiscal year 2015, we incurred restructuring charges of $780 million under the Phone Hardware Restructuring Plan, including severance expenses and other reorganization costs. In fiscal year 2016, we reversed $21 million of previously estimated restructuring charges related to contract termination costs. The actions associated with the Phone Hardware Restructuring Plan were substantially complete as of June 30, 2016, and are expected to be completed by the end of fiscal year 2017.

2016 Restructuring

In the fourth quarter of fiscal year 2016, management approved restructuring plans that would result in job eliminations, primarily across our smartphone hardware business and global sales. In addition to the elimination of 1,850 positions that were announced in May 2016, approximately 2,850 roles globally will be reduced during fiscal year 2017 as an extension of the earlier plan. These actions are expected to be completed by the end of the current fiscal year.

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In fiscal year 2016, we incurred restructuring charges of $501 million in connection with the 2016 restructuring plans, including severance expenses and other reorganization costs. We do not expect to incur additional charges for these restructuring plans in subsequent years.

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

Changes in the restructuring liability were as follows:

(In millions)	Severance	Other [(a)]	Total
Restructuring liability as of June 30, 2016	$470	$239	$709
Restructuring charges	0	0	0
Cash paid	(250)	(35)	(285)
Other	(7)	(4)	(11)
Restructuring liability as of December 31, 2016	$213	$200	$413

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

NOTE 14 — UNEARNED REVENUE

Unearned revenue by segment was as follows:

(In millions)	December 31, 2016	June 30, 2016
Productivity and Business Processes	$ 11,447	$12,497
Intelligent Cloud	9,749	11,472
More Personal Computing	3,034	3,334
Corporate and Other	10,450	6,606

Total	$ 34,680	$ 33,909

Revenue from Windows 10 is primarily recognized at the time of billing in the More Personal Computing segment, and the deferral and subsequent recognition of revenue is reflected in Corporate and Other in the table above. As of December 31, 2016 and June 30, 2016, we deferred a net $10.5 billion and $6.6 billion, respectively, in revenue related to Windows 10.

NOTE 15 — COMMITMENTS AND CONTINGENCIES

Capital Lease Commitments

We have capital leases for datacenters and corporate offices. As of December 31, 2016 and June 30, 2016, assets recorded under capital leases were $1.6 billion and $865 million, respectively, and accumulated depreciation associated with capital leases was $95 million and $57 million, respectively. For the three and six months ended December 31, 2016, property and equipment acquired under capital leases was $498 million and $765 million, respectively. We did not acquire any property and equipment under capital leases during the three or six months ended December 31, 2015. As of December 31, 2016 and June 30, 2016, capital lease obligations included in other current liabilities were $56 million and $25 million, respectively, and capital lease obligations included in other long-term liabilities were $1.5 billion and $761 million, respectively.

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Future minimum lease payments under non-cancellable capital leases as of December 31, 2016 are as follows:

(In millions)	
Year Ending June 30,	
2017 (excluding the six months ended December 31, 2016)	$62
2018	126
2019	129
2020	133
2021	136
Thereafter	1,529
Total [(a)]	$ 2,115

(a) As of December 31, 2016, capital leases included imputed interest of $581 million.

As of December 31, 2016, we had additional purchase obligations for capital leases executed but not yet recorded of $4.2 billion.

Contingencies

Patent and Intellectual Property Claims

IPCom patent litigation

IPCom GmbH & Co. ("IPCom") is a German company that holds a large portfolio of mobile technology-related patents spanning about 170 patent families and addressing a broad range of cellular technologies. IPCom has asserted 19 of these patents in litigation against Nokia Corporation ("Nokia") and many of the leading 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, in an inter partes review the United States Patent Trial and Appeal Board issued a final written decision that deemed unpatentable all asserted claims of the patent remaining at issue in the Delaware case. IDT 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 unlawful exploitation of standard essential patents. That case is set for trial in September 2018.

European copyright levies

We assumed from Nokia all potential liability due to Nokia's alleged failure to pay "private copyright levies" in various European countries based upon sale of memory cards and mobile phones that incorporate blank memory. The levies are based upon a 2001 European Union ("EU") Directive establishing a right for end users to make copies of copyrighted works for personal or private use, but also allowing the collection of levies based upon sales of blank media or recording devices to compensate copyright holders for private copying. Various collecting societies in EU countries initiated litigation against Nokia, stating it must pay levies not only based upon sales of blank memory cards, but also phones that include blank memory for data storage on the phones, regardless of actual usage of that memory. The most significant cases against Nokia were pending in Germany and Austria, due to both the high volume of sales and high levy amounts sought in these countries. We reached a settlement of the Austrian case in August 2016. In Germany, the only period for which settlement has not been reached is 2004-2007. In July, the

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German Supreme Court heard our appeal contesting the legality of the levy assessed on phones with music players and over five megabytes of memory. The Supreme Court issued a ruling in December 2016, finding that the levy may not be appropriate for phones that have the ability to receive music files only via Bluetooth or infrared inputs, and remanded for further proceedings. A new case schedule has not been set, and we are participating in industry-wide settlement negotiations with the collecting society.

Other patent and intellectual property claims

In addition to these cases, there were 58 other patent infringement cases pending against Microsoft as of December 31, 2016.

Antitrust, Unfair Competition, and Overcharge Class Actions

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

The trial of the British Columbia action commenced in May 2016. The plaintiffs filed their case in chief in August 2016, setting out claims made, authorities, and evidence in support of their claims. A six-month oral hearing is scheduled to commence in September 2017, consisting of cross examination on witness affidavits. The Ontario and Quebec cases are inactive.

Other Antitrust Litigation and Claims

China State Administration for Industry and Commerce investigation

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

Product-Related Litigation

U.S. cell phone litigation

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

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

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

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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 has been dormant for more than two years.

Other Contingencies

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

As of December 31, 2016, we accrued aggregate legal liabilities of $415 million. 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

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

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2016, no shares had been repurchased under this $40.0 billion share repurchase program.

We repurchased the following shares of our common stock through our share repurchase program approved on September 16, 2013:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Shares of common stock repurchased	59	66	122	155

Value of common stock repurchased	$ 3,533	$ 3,600	$ 7,083	$ 7,600

The above table excludes shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards.

Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount (in millions)	Payment Date
Fiscal year 2017				
September 20, 2016	$ 0.39	November 17, 2016	$ 3,024	December 8, 2016
November 30, 2016	$ 0.39	February 16, 2017	$ 3,014	March 9, 2017

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Declaration Date	Dividend Per Share	Record Date	Total Amount (in millions)	Payment Date
Fiscal year 2016				
September 15, 2015	$ 0.36	November 19, 2015	$ 2,868	December 10, 2015
December 2, 2015	$ 0.36	February 18, 2016	$ 2,842	March 10, 2016

The dividend declared on November 30, 2016 was included in other current liabilities as of December 31, 2016.

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,	
	2016	2015	2016	2015
Derivatives				
Accumulated other comprehensive income balance, beginning of period	$ 315	$ 647	$ 352	$ 590
Unrealized gains, net of tax effects of $3, $15, $4, and $43	449	122	484	283
Reclassification adjustments for gains included in revenue	(172)	(181)	(247)	(290)
Tax expense included in provision for income taxes	3	10	6	15
Amounts reclassified from accumulated other comprehensive income	(169)	(171)	(241)	(275)
Net current period other comprehensive income (loss)	280	(49)	243	8
Accumulated other comprehensive income balance, end of period	$ 595	$ 598	$ 595	$ 598

Investments

Accumulated other comprehensive income balance, beginning of period	$3,024	$2,598	$2,941	$3,169
Unrealized gains (losses), net of tax effects of $(292), $122, $(110), and $(183)	(543)	228	(204)	(338)
Reclassification adjustments for gains included in other income (expense), net	(694)	(104)	(1,088)	(112)
Tax expense included in provision for income taxes	243	36	381	39
Amounts reclassified from accumulated other comprehensive income	(451)	(68)	(707)	(73)
Net current period other comprehensive income (loss)	(994)	160	(911)	(411)
Accumulated other comprehensive income balance, end of period	$2,030	$2,758	$2,030	$2,758

Translation adjustments and other

Accumulated other comprehensive loss balance, beginning of period	$(1,658)	$(1,507)	$(1,756)	$(1,237)
Translation adjustments and other, net of tax effects of $0, $(9), $7, and $(21)	(455)	(76)	(357)	(346)
Accumulated other comprehensive loss balance, end of period	$ (2,113)	$(1,583)	$ (2,113)	$(1,583)
Accumulated other comprehensive income, end of period	$512	$ 1,773	$512	$ 1,773

NOTE 18 — SEGMENT INFORMATION

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

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In December 2016, we completed our acquisition of LinkedIn. LinkedIn is reported as part of our Productivity and Business Processes segment. LinkedIn offers services that can be used by customers to transform the way they hire, market, sell, and learn on a global basis through Talent Solutions, Marketing Solutions, and Premium Subscriptions.

- Talent Solutions is comprised of Hiring and Learning and Development. Hiring provides services to recruiters that enable them to attract, recruit, and hire talent. Learning and Development provides subscriptions to enterprises and individuals to online learning content.
- Marketing Solutions enable enterprises and individuals to advertise to LinkedIn's member base through relevant content. Advertising (consisting of content-based, graphic display, text link, and programmatic) is shown primarily on LinkedIn.com and its mobile applications.
- Premium Subscriptions (inclusive of Sales Solutions) enable professionals to manage their professional identity, grow their network, and connect with talent.

Our reportable segments are described below.

Productivity and Business Processes

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

- Office Commercial, including volume licensing and subscriptions to Office 365 commercial for products and services such as 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 Skype, Outlook.com, and OneDrive.
- Microsoft Dynamics ("Dynamics") business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.
- LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.

Intelligent Cloud

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

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

More Personal Computing

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

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

- Search advertising.

Corporate and Other 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 Windows 10 revenue recognition.

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

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certain contracts is allocated among the segments based on the relative value of the underlying products and services, which can include allocation based on actual prices charged, prices when sold separately, or estimated costs plus a profit margin. Cost of revenue is allocated in certain cases based on a relative revenue methodology. Operating expenses that are allocated primarily include those relating to marketing of products and services from which multiple segments benefit, and are generally allocated based on relative gross margin.

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

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,	
	2016	2015	2016	2015
Revenue				
Productivity and Business Processes	$7,382	$6,690	$14,040	$12,996
Intelligent Cloud	6,861	6,343	13,243	12,235
More Personal Computing	11,823	12,473	21,117	21,935
Corporate and Other [(a)]	(1,976)	(1,710)	(3,857)	(2,991)
Total revenue	$ 24,090	$ 23,796	$ 44,543	$ 44,175

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Operating income (loss)				
Productivity and Business Processes	$3,256	$3,292	$6,376	$6,448
Intelligent Cloud	2,398	2,568	4,456	4,959

More Personal Computing	2,499	1,876	4,427	3,403
Corporate and Other [(a)]	(1,976)	(1,710)	(3,857)	(2,991)
Total operating income	$6,177	$ 6,026	$ 11,402	$11,819

(a) Corporate and Other revenue and operating loss for the three and six months ended December 31, 2016 and 2015 consisted of the net revenue deferral related to sales of Windows 10.

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.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the "Company") as of December 31, 2016, 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, 2016 and 2015. 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, 2016, 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 28, 2016, 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, 2016 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 26, 2017

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

Note About Forward-Looking Statements

This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors." These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," " "opportunity," "plan," "may," "should," "will," "would," "will be," "will continue," "will likely result," and similar expression 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 of Financial Condition and Results of Operations" (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 of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our Annual Report on Form 10-K for the year ended June 30, 2016, and our Financial Statements and the accompanying Notes to Financial Statements (Part 1, Item 1 of this Form 10-Q).

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. Our strategy is to build best-in-class platforms and productivity services for a mobile-first, cloud-first world. We develop, license, and support a wide range of software products, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people's lives.

We generate revenue by licensing and supporting an array of software products, by offering a wide range 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.

Highlights* from the second quarter of fiscal year 2017 included:

- Commercial cloud annualized revenue run rate** exceeded $14.0 billion.
- Office Commercial revenue grew 5%, driven by Office 365 commercial revenue growth of 47%.
- Office Consumer revenue grew 22%, and Office 365 consumer subscribers increased to 24.9 million.
- Microsoft Dynamics ("Dynamics") revenue grew 7%, driven by Dynamics 365 revenue growth.
- Server products and cloud services revenue grew 12%, driven by Microsoft Azure ("Azure") revenue growth.
- Azure revenue grew 93%, with Azure compute usage more than doubling year-over-year.

- Windows original equipment manufacturer licensing (“Windows OEM”) revenue increased 5%.
- Windows Commercial revenue grew 5%, driven by multi-year agreement revenue.
- Search advertising revenue, excluding traffic acquisition costs, grew 10%, driven by increased revenue per search and search volume.

* Highlights are presented based on segment results.

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

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

In November 2016, we completed the sale of our feature phone business for $350 million.

In July 2015, we announced a plan to restructure our phone business to better focus and align resources. In May 2016, we announced plans to further streamline our smartphone hardware business. These changes in the phone business reinforce 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. As anticipated, our change in phone strategy resulted in a reduction in units sold and associated expenses in fiscal year 2016, and this trend is expected to continue in fiscal year 2017.

Industry Trends

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

Economic Conditions, Challenges, and Risks

The 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 infrastructure and devices will continue to increase our operating costs and may decrease our operating margins.

Our success is highly dependent on our ability to attract and retain qualified employees. We hire a mix of university and industry talent worldwide. Microsoft competes for talented individuals globally by offering an exceptional working environment, broad customer reach, scale in resources, the ability to grow one's career across many different products and businesses, and competitive compensation and benefits. Aggregate demand for our software, services, and devices is correlated to global macroeconomic and geopolitical factors, which remain dynamic.

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. The strengthening of the U.S. dollar relative to certain foreign currencies throughout fiscal year 2016, and continuing into fiscal year 2017, negatively impacted reported revenue and reduced reported expenses from our international operations.

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.

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 in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) is also presented on this basis. All differences between our internal management reporting basis and accounting principles generally accepted in the United States ("U.S. GAAP"), along with certain corporate-level and other activity, are included in Corporate and Other. During the periods presented, we reported

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our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing.

LinkedIn is reported as part of our Productivity and Business Processes segment. LinkedIn offers services that can be used by customers to transform the way they hire, market, sell, and learn on a global basis through Talent Solutions, Marketing Solutions, and Premium Subscriptions.

Additional information on our reportable segments is contained in Note 18 – Segment Information in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2016	2015		2016	2015	
Revenue	$ 24,090	$ 23,796	1%	$ 44,543	$ 44,175	1%
Gross margin	$14,189	$13,924	2%	$26,798	$27,096	(1)%
Operating income	$6,177	$6,026	3%	$11,402	$11,819	(4)%
Diluted earnings per share	$ 0.66	$0.62	6%	$ 1.26	$1.23	2%

Three months ended December 31, 2016 compared with three months ended December 31, 2015

Revenue increased $294 million or 1%, driven by growth in Productivity and Business Processes and Intelligent Cloud, offset in part by lower revenue from More Personal Computing and an increase in the net revenue deferral from Windows 10. Windows 10 revenue is primarily recognized at the time of billing in the More Personal Computing segment, and the deferral and subsequent recognition of revenue is reflected in Corporate and Other. Productivity and Business Processes revenue increased, driven by higher revenue from Office 365 and the acquisition of LinkedIn. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue decreased, mainly due to lower revenue from Devices and Gaming, offset in part by higher revenue from Windows and Search advertising. Revenue included an unfavorable foreign currency impact of 2%.

Operating income increased $151 million or 3%, primarily due to higher gross margin, offset in part by an increase in operating expenses. Operating income included an unfavorable foreign currency impact of 4%. Gross margin increased $265 million or 2%, driven by higher revenue. Gross margin included an unfavorable foreign currency impact of 2%.

Key changes in expenses were:

- Cost of revenue increased slightly, mainly due to growth in our commercial cloud, the acquisition of LinkedIn, and higher Search advertising traffic acquisition costs, offset in part by a reduction in phone sales.

- Research and development expenses increased $162 million or 6%, primarily due to increased strategic investments to drive cloud engineering and LinkedIn expenses, offset in part by a reduction in phone expenses.
- Sales and marketing expenses increased $111 million or 3%, primarily due to LinkedIn expenses and increased investments to drive sales capacity in our commercial cloud, offset in part by a reduction in phone expenses.
- General and administrative expenses decreased $159 million or 15%, primarily due to the benefit of a legal settlement in the current year, lower employee-related expenses, and a reduction in phone expenses, offset in part by LinkedIn expenses.

Diluted earnings per share (“EPS”) was $0.66 for the three months ended December 31, 2016. Current year diluted EPS was negatively impacted by the net revenue deferral from Windows 10, which resulted in a decrease to diluted EPS of $0.17. Diluted EPS was $0.62 for the three months ended December 31, 2015. Prior year diluted EPS was negatively impacted by the net revenue deferral from Windows 10, which resulted in a decrease to diluted EPS of $0.14.

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Six months ended December 31, 2016 compared with six months ended December 31, 2015

Revenue increased $368 million or 1%, driven by growth in Productivity and Business Processes and Intelligent Cloud, offset in part by an increase in the net revenue deferral from Windows 10 and lower revenue from More Personal Computing. Productivity and Business Processes revenue increased, driven by higher revenue from Office 365. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue decreased, mainly due to lower revenue from Devices and Gaming, offset in part by higher revenue from Windows and Search advertising.

Operating income decreased $417 million or 4%, primarily due to lower gross margin and an increase in operating expenses. Operating income included an unfavorable foreign currency impact of 5%. Gross margin decreased $298 million or 1%, driven by higher cost of revenue, offset in part by higher revenue. Gross margin included an unfavorable foreign currency impact of 2%.

Key changes in expenses were:

- Cost of revenue increased $666 million or 4%, mainly due to growth in our commercial cloud and higher Search advertising traffic acquisition costs, offset in part by a reduction in phone sales.
- Research and development expenses increased $306 million or 5%, primarily due to increased strategic investments to drive cloud engineering and LinkedIn expenses, offset in part by a reduction in phone expenses.
- General and administrative expenses decreased $198 million or 9%, primarily due to the benefit of a legal settlement in the current year, lower employee-related expenses, and a reduction in phone expenses, offset in part by LinkedIn expenses.

Diluted EPS was $1.26 for the six months ended December 31, 2016. Current year diluted EPS was negatively impacted by the net revenue deferral from Windows 10, which resulted in a decrease to diluted EPS of $0.33. Diluted EPS was $1.23 for the six months ended December 31, 2015. Prior year diluted EPS was negatively impacted by the net revenue deferral from Windows 10, which resulted in a decrease to diluted EPS of $0.23.

SEGMENT RESULTS OF OPERATIONS

(In millions, except percentages)	Three Months Ended December 31, 2016	2015	Percentage Change	Six Months Ended December 31, 2016	2015	Percentage Change
Revenue						
Productivity and Business Processes	$7,382	$6,690	10%	$14,040	$12,996	8%
Intelligent Cloud	6,861	6,343	8%	13,243	12,235	8%
More Personal Computing	11,823	12,473	(5)%	21,117	21,935	(4)%
Corporate and Other	(1,976)	(1,710)	(16)%	(3,857)	(2,991)	(29)%

Total revenue	$ 24,090	$ 23,796	1%	$ 44,543	$ 44,175	1%
Operating income (loss)						
Productivity and Business Processes	$3,256	$3,292	(1)%	$6,376	$6,448	(1)%
Intelligent Cloud	2,398	2,568	(7)%	4,456	4,959	(10)%
More Personal Computing	2,499	1,876	33%	4,427	3,403	30%
Corporate and Other	(1,976)	(1,710)	(16)%	(3,857)	(2,991)	(29)%
Total operating income	$6,177	$6,026	3%	$11,402	$11,819	(4)%

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Reportable Segments

Three months ended December 31, 2016 compared with three months ended December 31, 2015

Productivity and Business Processes

Revenue increased $692 million or 10%, primarily due to higher revenue from Office 365 and the acquisition of LinkedIn. Revenue included an unfavorable foreign currency impact of 2%.

- Office Commercial revenue increased $289 million or 5%, driven by higher revenue from Office 365 commercial, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial. Revenue included an unfavorable foreign currency impact of 2%.
- LinkedIn revenue was $228 million, primarily comprised of revenue from Talent Solutions and Marketing Solutions.
- Office Consumer revenue increased $156 million or 22%, driven by higher revenue from Office 365 consumer, mainly due to growth in subscribers.
- Dynamics revenue increased 7%, due to higher revenue from Dynamics 365.

Operating income decreased slightly, primarily due to higher operating expenses, offset in part by an increase in gross margin. Operating income included an unfavorable foreign currency impact of 2%. Operating expenses increased $288 million or 13%, mainly due to LinkedIn expenses and investments in cloud engineering. Operating expenses included $310 million related to our acquisition of LinkedIn, including $52 million of amortization of acquired intangible assets. Sales and marketing expenses increased $165 million or 13%, and research and development expenses increased $129 million or 20%. Gross margin increased $252 million or 5%, driven by higher revenue, offset in part by higher cost of revenue. Cost of revenue increased $440 million or 37%, driven by an increased mix of cloud offerings and our acquisition of LinkedIn. Cost of revenue included $119 million related to our acquisition of LinkedIn, including $72 million of amortization of acquired intangible assets.

Intelligent Cloud

Revenue increased $518 million or 8%, primarily due to higher revenue from server products and cloud services. Revenue included an unfavorable foreign currency impact of 2%.

- Server products and cloud services revenue grew $577 million or 12%, driven by Azure revenue growth of 93%, and 5% growth in revenue from our server products licensed on-premises. Revenue included an unfavorable foreign currency impact of 2%.
- Enterprise Services revenue decreased 4%, driven by a decline in revenue from custom support agreements, offset in part by higher revenue from Premier Support Services and Microsoft Consulting Services.

Operating income decreased $170 million or 7%, primarily due to higher operating expenses, offset in part by higher gross margin. Operating income included an unfavorable foreign currency impact of 3%. Operating expenses increased $264 million or 12%, mainly due to higher sales and marketing expenses and research and development expenses. Sales and marketing expenses increased $154 million or 15% and research and development expenses increased $145 million or 19%, driven by strategic investments to drive cloud engineering, sales capacity, and developer engagement. Gross margin increased $94 million or 2%, driven by higher revenue, offset in part by higher cost of revenue. Gross margin included an unfavorable foreign currency impact of 2%. Cost of revenue increased $424 million or 26%, primarily driven by investments to increase capacity and meet demand for the capabilities of our cloud offerings.

More Personal Computing

Revenue decreased $650 million or 5%, mainly due to lower revenue from Devices and Gaming, offset in part by higher revenue from Windows and Search advertising.

- Windows revenue increased $149 million or 3%, mainly due to higher revenue from Windows OEM and Windows Commercial, offset in part by lower revenue from patent licensing. Windows OEM revenue increased 5%. Windows OEM Pro revenue grew 6%, slightly outperforming a strengthening commercial PC market, and Windows OEM non-Pro revenue grew 5%, outperforming the consumer PC market.

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- Windows Commercial revenue grew 5%, driven by renewals and a higher mix of premium multi-year agreements.
- Patent licensing revenue decreased 25%, mainly due to a decline in licensed units and license revenue per unit.
- Search advertising revenue increased $177 million or 12%. Search advertising revenue, excluding traffic acquisition costs, increased 10%, primarily driven by growth in Bing, due to higher revenue per search and search volume.
- Devices revenue decreased $914 million or 35%, mainly due to lower revenue from phones. Phone revenue decreased $878 million or 81%, driven by a reduction in volume of phones sold.
- Gaming revenue decreased $104 million or 3%, primarily due to lower Xbox hardware revenue, offset in part by higher revenue from Xbox software and services. Xbox hardware revenue decreased 22%, mainly due to lower prices of consoles sold and a decline in volume of consoles sold. Xbox software and services revenue increased 18%, driven by a higher volume of Xbox Live transactions and revenue per transaction.

Operating income increased $623 million or 33%, due to lower operating expenses and higher gross margin. Operating income included an unfavorable foreign currency impact of 4%. Operating expenses decreased $438 million or 12%. Sales and marketing expenses decreased $208 million or 13%, driven by a reduction in phone expenses and Surface launch-related expenses in the prior year. General and administrative expenses decreased $118 million or 31%, driven by the benefit of a legal settlement in the current year and a reduction in phone expenses. Research and development expenses decreased $112 million or 8%, driven by a reduction in phone expenses. Gross margin increased $185 million or 3%, driven by lower cost of revenue, offset in part by lower revenue. Gross margin included an unfavorable foreign currency impact of 2%. Cost of revenue decreased $835 million or 12%, driven by a reduction in phone sales and lower Xbox hardware cost of revenue, offset in part by an increase in Xbox software and services cost of revenue and Search advertising traffic acquisition costs.

Six months ended December 31, 2016 compared with six months ended December 31, 2015

Productivity and Business Processes

Revenue increased $1.0 billion or 8%, primarily due to higher revenue from Office 365. Revenue included an unfavorable foreign currency impact of 2%.

- Office Commercial revenue increased $553 million or 5%, driven by higher revenue from Office 365 commercial, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial. Revenue included an unfavorable foreign currency impact of 3%.
- LinkedIn revenue was $228 million, primarily comprised of revenue from Talent Solutions and Marketing Solutions.
- Office Consumer revenue increased $214 million or 15%, driven by higher revenue from Office 365 consumer, mainly due to growth in subscribers.
- Dynamics revenue increased 9%, due to higher revenue from Dynamics 365.

Operating income decreased $72 million or 1%, primarily due to higher operating expenses, offset in part by higher gross margin. Operating income included an unfavorable foreign currency impact of 3%. Operating expenses increased $323 million or 7%, mainly due to LinkedIn expenses and investments in cloud engineering. Research and development expenses increased $216 million or 17%, and sales and marketing expenses increased $119 million or 5%. Gross margin increased $251 million or 2%, driven by higher revenue, offset in part by higher cost of revenue. Gross margin included an unfavorable foreign currency impact of 2%. Cost of revenue increased $793 million or 35%, driven by an increased mix of cloud offerings.

Intelligent Cloud

Revenue increased $1.0 billion or 8%, primarily due to higher revenue from server products and cloud services. Revenue included an unfavorable foreign currency impact of 2%.

- Server products and cloud services revenue grew $1.1 billion or 11%, driven by Azure revenue growth of 104%, and 4% growth in revenue from our server products licensed on-premises. Revenue included an unfavorable foreign currency impact of 2%.

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- Enterprise Services revenue decreased 2%, driven by a decline in revenue from custom support agreements, offset in part by higher revenue from Premier Support Services and Microsoft Consulting Services.

Operating income decreased $503 million or 10%, primarily due to higher operating expenses, offset in part by higher gross margin. Operating income included an unfavorable foreign currency impact of 3%. Operating expenses increased $672 million or 16%, mainly due to higher sales and marketing expenses and research and development expenses. Sales and marketing expenses increased $345 million or 18% and research and development expenses increased $341 million or 22%, driven by strategic investments to drive cloud engineering, sales capacity, and developer engagement. Gross margin increased $169 million or 2%, driven by higher revenue, offset in part by higher cost of revenue. Gross margin included an unfavorable foreign currency impact of 2%. Cost of revenue increased $839 million or 27%, driven primarily by investments to increase capacity and meet demand for the capabilities of our cloud offerings.

More Personal Computing

Revenue decreased $818 million or 4%, mainly due to lower revenue from Devices and Gaming, offset in part by higher revenue from Windows and Search advertising.

- Windows revenue increased $162 million or 2%, mainly due to higher revenue from Windows OEM and Windows Commercial. Windows OEM revenue increased 3%. Windows OEM Pro revenue grew 4%, generally in line with the commercial PC market, and Windows OEM non-Pro revenue grew 2%, outperforming the consumer PC market. Windows Commercial revenue grew 2%, driven by renewals and a higher mix of premium multi-year agreements.
- Search advertising revenue increased $586 million or 24%. Search advertising revenue, excluding traffic acquisition costs, increased 9%, primarily driven by growth in Bing, due to higher revenue per search and search volume.
- Devices revenue decreased $1.4 billion or 31%, mainly due to lower revenue from phones, offset in part by higher Surface revenue. Phone revenue decreased $1.7 billion or 76%, driven by a reduction in volume of phones sold. Surface revenue increased $223 million or 11%, primarily driven by a higher mix of premium devices sold.
- Gaming revenue decreased $214 million or 4%, primarily due to lower Xbox hardware revenue, offset in part by higher revenue from Xbox software and services. Xbox hardware revenue decreased 23%, mainly due to lower prices of consoles sold and a decline in volume of consoles sold. Xbox software and services revenue increased 13%, driven by a higher volume of Xbox Live transactions and revenue per transaction.

Operating income increased $1.0 billion or 30%, due to lower operating expenses and higher gross margin. Operating income included an unfavorable foreign currency impact of 4%. Operating expenses decreased $876 million or 13%. Sales and marketing expenses decreased $453 million or 15%, driven by a reduction in phone expenses as well as Windows 10 and Surface launch-related expenses in the prior year. Research and development expenses decreased $251 million or 8%, driven by a reduction in phone expenses. General and administrative expenses decreased $172 million or 22%, driven by a reduction in phone expenses and the benefit of a legal settlement in the current year. Gross margin increased $148 million or 1%, driven by lower cost of revenue, offset in part by lower revenue. Gross margin included an unfavorable foreign currency impact of 2%. Cost of revenue decreased $966 million or 8%, driven by a reduction in phone sales and lower Xbox hardware cost of revenue, offset in part by an increase in Search advertising traffic acquisition costs and Xbox software and services cost of revenue. Surface cost of revenue increased, primarily driven by a higher mix of premium devices sold.

Corporate and Other

Corporate and Other revenue is comprised of revenue deferrals related to Windows 10. Corporate and Other operating income (loss) is comprised of Windows 10 revenue deferrals and corporate-level activity not specifically allocated to a segment, including impairment, integration, and restructuring expenses.

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Three months ended December 31, 2016 compared with three months ended December 31, 2015

Revenue decreased and operating loss increased, due to a $266 million increase in the net revenue deferral from Windows 10. During the three months ended December 31, 2016 and 2015, we deferred net revenue from Windows 10 of $2.0 billion and $1.7 billion, respectively.

Six months ended December 31, 2016 compared with six months ended December 31, 2015

Revenue decreased and operating loss increased, due to an $866 million increase in the net revenue deferral from Windows 10. During the six months ended December 31, 2016 and 2015, we deferred net revenue from Windows 10 of $3.9 billion and $3.0 billion, respectively.

OPERATING EXPENSES

Research and Development

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2016	2015		2016	2015	
Research and development	$ 3,062	$ 2,900	6%	$ 6,168	$ 5,862	5%
As a percent of revenue	13%	12%	1ppt	14%	13%	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, 2016 compared with three months ended December 31, 2015

Research and development expenses increased $162 million or 6%, primarily due to increased strategic investments to drive cloud engineering and LinkedIn expenses, offset in part by a reduction in phone expenses. Expenses included $82 million related to our acquisition of LinkedIn.

Six months ended December 31, 2016 compared with six months ended December 31, 2015

Research and development expenses increased $306 million or 5%, primarily due to increased strategic investments to drive cloud engineering and LinkedIn expenses, offset in part by a reduction in phone expenses.

Sales and Marketing

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2016	2015		2016	2015	
Sales and marketing	$ 4,071	$ 3,960	3%	$ 7,304	$ 7,293	0%
As a percent of revenue	17%	17%	0ppt	16%	17%	(1)ppt

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

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Three months ended December 31, 2016 compared with three months ended December 31, 2015

Sales and marketing expenses increased $111 million or 3%, primarily due to LinkedIn expenses and increased investments to drive sales capacity in our commercial cloud, offset in part by a reduction in phone expenses. Expenses included $195 million related to our acquisition of LinkedIn, including $52 million of amortization of acquired intangible assets.

Six months ended December 31, 2016 compared with six months ended December 31, 2015

Sales and marketing expenses increased slightly, primarily due to increased investments to drive sales capacity in our commercial cloud and LinkedIn expenses, offset in part by a reduction in phone expenses and Windows 10 launch-related expenses in the prior year.

General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2016	2015		2016	2015	
General and administrative	$ 879	$ 1,038	(15)%	$ 1,924	$ 2,122	(9)%
As a percent of revenue	4%	4%	0ppt	4%	5%	(1)ppt

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

Three months ended December 31, 2016 compared with three months ended December 31, 2015

General and administrative expenses decreased $159 million or 15%, primarily due to the benefit of a legal settlement in the current year, lower employee-related expenses, and a reduction in phone expenses, offset in part by LinkedIn expenses. Expenses included $33 million related to our acquisition of LinkedIn.

Six months ended December 31, 2016 compared with six months ended December 31, 2015

General and administrative expenses decreased $198 million or 9%, primarily due to the benefit of a legal settlement in the current year, lower employee-related expenses, and a reduction in phone expenses, offset in part by LinkedIn expenses.

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,	
	2016	2015	2016	2015
Dividends and interest income	$ 311	$ 200	$ 604	$ 399
Interest expense	(521)	(309)	(958)	(558)
Net recognized gains on investments	698	106	1,103	108
Net losses on derivatives	(46)	(156)	(140)	(259)
Net gains (losses) on foreign currency remeasurements	(82)	2	(134)	(34)
Other	(174)	(14)	(189)	(107)
Total	$ 186	$ (171)	$ 286	$ (451)

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

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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, 2016 compared with three months ended December 31, 2015

Dividends and interest income increased primarily due to higher portfolio balances and yields. Interest expense increased primarily due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities. Other-than-temporary impairments were $21 million for the three months ended December 31, 2016, compared with $127 million in the prior year. Net losses on derivatives decreased due to gains on commodity derivatives in the current period as compared to losses in the prior period and lower losses on foreign currency and equity derivatives. Other reflects recognized losses from divestitures and certain joint ventures.

Six months ended December 31, 2016 compared with six months ended December 31, 2015

Dividends and interest income increased primarily due to higher portfolio balances and yields. Interest expense increased due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities. Other-than-temporary impairments were $39 million for the six months ended December 31, 2016, compared with $162 million in the prior year. Net losses on derivatives decreased due to lower losses on commodity and foreign currency derivatives, offset in part by losses on equity derivatives in the current period as compared to gains in the prior period. Other reflects recognized losses on divestitures and certain joint ventures.

INCOME TAXES

Our effective tax rate for the three months ended December 31, 2016 and 2015 was 18% and 14%, respectively, and our effective tax rate for the six months ended December 31, 2016 and 2015 was 15% and 13%, 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 higher 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. The prior year's second quarter effective tax rate also included a tax benefit related to the retroactive reinstatement of the U.S. research and development tax credit. The current year-to-date effective tax rate was higher 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.

Tax contingencies and other income tax liabilities were $13.3 billion and $11.8 billion as of December 31, 2016 and June 30, 2016, respectively, and are included in other long-term liabilities. This increase relates primarily to current period intercompany transfer pricing and foreign tax credits.

While we settled a portion of the Internal Revenue Service ("IRS") audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and settled a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. We also continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of December 31, 2016, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2016, 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.

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FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $122.8 billion as of December 31, 2016, compared with $113.2 billion as of June 30, 2016. Equity and other investments were $8.9 billion as of December 31, 2016, compared with $10.4 billion as of June 30, 2016. Our short-term investments are primarily intended to facilitate liquidity and for capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities 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 as of December 31, 2016, $116.3 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 $2.2 billion. As of December 31, 2016, approximately 85% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 3% were invested in corporate notes and bonds of U.S. companies, and approximately 4% were invested in U.S. mortgage- and asset-backed securities, all of which are denominated in U.S. dollars. The remaining cash equivalents and short-term investments held by our foreign subsidiaries were invested in foreign securities.

Securities lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our consolidated balance sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Collateral received is recorded as an asset with a corresponding liability. Our securities lending payable balance was $1.3 billion as of December 31, 2016. Our average and maximum securities lending payable balances for the three months ended December 31, 2016 were $719 million and $1.5 billion, respectively. Our average and maximum securities lending payable balances for the six months ended December 31, 2016 were $615 million and $1.5 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.

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Cash Flows

Cash from operations increased $3.3 billion to $17.8 billion for the six months ended December 31, 2016, mainly due to an increase in cash received from customers and an income tax refund for overpayment of estimated taxes. Cash from financing increased $21.8 billion to $17.3 billion, mainly due to a $21.3 billion increase in proceeds from issuances of debt, net of repayments, and a $474 million decrease in cash used for common stock repurchases, offset in part by a $481 million increase in dividends paid. Cash used in investing increased $24.8 billion to $33.2 billion, mainly due to a $24.0 billion increase in cash used for acquisitions of companies, net of cash acquired, and purchases of intangibles and other assets, a $771 million increase in cash used for additions to property and equipment, and a $682 million increase in cash used for net investment purchases, sales, and maturities, offset in part by a $639 million increase in cash from securities lending activities.

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 in the Notes to Financial Statements (Part 1, Item 1 of this Form 10-Q) for further discussion.

Unearned Revenue

Unearned revenue as of December 31, 2016 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 as of December 31, 2016 also included payments for: Windows 10 licenses; post-delivery support and consulting services to be performed in the future; Office 365 subscriptions; Xbox Live subscriptions; LinkedIn; Dynamics business solutions products; Skype prepaid credits and subscriptions; bundled products and services; 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, 2016:

(In millions)	
Three Months Ending,	
March 31, 2017	$11,411
June 30, 2017	7,634
September 30, 2017	4,272
December 31, 2017	2,768
Thereafter	8,595

Total	$	34,680

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

Share Repurchases

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

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2016, no shares had been repurchased under this $40.0 billion share repurchase program.

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During the three and six months ended December 31, 2016, we repurchased 59 million shares and 122 million shares of our common stock for $3.5 billion and $7.1 billion, respectively, through the share repurchase program approved on September 16, 2013. All repurchases were made using cash resources.

Dividends

See Note 16 – Stockholders' Equity in the Notes to Financial Statements (Part 1, Item 1 of this Form 10-Q) for further discussion.

Off-Balance Sheet Arrangements

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

Other Planned Uses of Capital

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology, as well as continue making acquisitions that align with our business strategy. Additions to property and equipment will continue, including new facilities, datacenters, and computer systems for research and development, sales and marketing, support, and administrative staff. We expect capital expenditures to increase in coming years to support growth in our cloud offerings. We have operating 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 in the Notes to Financial Statements (Part 1, Item 1 of this Form 10-Q) for further discussion.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

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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.

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.

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.

We currently are evaluating the impact of the new standard related to revenue recognition, which we anticipate will have a material impact on our consolidated financial statements. See Note 1 – Accounting Policies in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Impairment of Investment Securities

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

Goodwill

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or

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circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit.

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

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

Research and Development Costs

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

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. 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 deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized on our consolidated financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our consolidated financial statements.

Inventories

Inventories are stated at average cost, subject to the lower of cost or market. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. These reviews include analysis of demand forecasts, product life cycle status, product development plans, current sales levels, pricing strategy, and component cost trends. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign exchange rates, interest rates, credit risk, 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.

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.

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The following table sets forth the one-day VaR for substantially all of our positions as of December 31, 2016 and June 30, 2016 and for the three months ended December 31, 2016:

(In millions)

	December 31, 2016	June 30, 2016	Three Months Ended December 31, 2016		
Risk Categories			Average	High	Low
Foreign currency	$ 175	$ 92	$ 188	$ 229	$ 155
Interest rate	$ 122	$58	$101	$124	$83
Equity	$ 125	$157	$141	$153	$125
Commodity	$ 11	$12	$11	$12	$9

Total one-day VaR for the combined risk categories was $272 million as of December 31, 2016 and $225 million as of June 30, 2016. The total VaR is 37% and 29% less as of December 31, 2016 and June 30, 2016, 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, 2016 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 – Commitments and Contingencies in the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding legal proceedings in which we are involved.

ITEM 1A. RISK FACTORS

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

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

Competition in the technology sector

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

Competition among platforms, ecosystems, and devices

An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A well-established ecosystem creates beneficial network effects among users, application developers, and the platform provider that can accelerate growth. Establishing significant scale in the marketplace is necessary to achieve and maintain attractive margins. We face significant competition from firms that provide competing platforms, applications, and services.

- A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has succeeded with some consumer products such as personal computers, tablets, phones, gaming consoles, and wearables. Competitors pursuing this model also earn revenue from services integrated with the hardware and software platform. We also offer some vertically-integrated hardware and software products and services. To the extent we shift a portion of our business to a vertically integrated model we increase our cost of revenue and reduce our operating margins.
- We derive substantial revenue from licenses of Windows operating systems on personal computers. We face significant competition from competing platforms developed for new devices and form factors such as smartphones and tablet computers. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users are increasingly turning to these devices to perform functions that in the past were performed by personal computers. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract application developers to our PC operating system

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

- Competing platforms have content and application marketplaces (sometimes referred to as “stores”) with scale and significant installed bases. The variety and utility of content and applications available on a platform are important to device purchasing decisions. Users sometimes incur costs to move data and buy new content and applications when switching platforms. To compete, we must successfully enlist developers to write applications for our marketplace and ensure that these applications have high quality, customer appeal, and value. Efforts to compete with competitors’ content and application marketplaces may increase our cost of revenue and lower our operating margins.

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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 investment in gaining insights from data is becoming central to the value of the services we deliver to customers, to our operational efficiency and key opportunities in monetization, customer perceptions of quality, and operational efficiency. Besides software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs will reduce the operating margins we have previously achieved. Whether we succeed in cloud-based services depends on our execution in several areas, including:

- Continuing to bring to market compelling cloud-based experiences that generate increasing traffic and market share.
- Maintaining the utility, compatibility, and performance of our cloud-based services on the growing array of computing devices, including PCs, smartphones, tablets, gaming consoles, and other television-related devices.
- Continuing to enhance the attractiveness of our cloud platforms to third-party developers.
- Ensuring our cloud-based services meet the reliability expectations of our customers and maintain the security of their data.
- Making our suite of cloud-based services platform-agnostic, available on a wide range of devices and ecosystems, including those of our competitors.

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

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 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 to existing users of Windows 7 and 8.1, has been the most ambitious update effort we have ever undertaken. We did extensive preparation and ongoing compatibility testing for applications and devices to help ensure a positive experience for our users installing Windows 10. We also consistently promoted the update to Windows 7 and 8.1 users. However, negative upgrade experiences could adversely affect the reception of Windows 10 in the marketplace and may lead to litigation or regulatory actions by customers and government agencies. In addition, we anticipate that Windows 10 will enable new post-license monetization opportunities beyond initial license revenues. Our inability to realize these opportunities to the extent we expect could have an adverse impact on our revenues. Finally, our practices around data collection, use, and management in Windows 10 are subject to regulatory review, and may result in decisions directing us to change these practices and imposing fines. If so, we could face negative public reaction, degraded user experiences, and reduced flexibility in product design.

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

Acquisitions, joint ventures, and strategic alliances may have an adverse effect on our business. We expect to continue making acquisitions and entering into joint ventures and strategic alliances as part of our long-term business strategy. In December 2016, we completed our acquisition of LinkedIn for $27 billion. The LinkedIn acquisition and other transactions and arrangements involve significant challenges and risks, including that they do not advance our business strategy, that we get an unsatisfactory return on our investment, that we have difficulty integrating new employees, business systems, and technology, or that they distract management from our other businesses. If an arrangement fails to adequately anticipate changing circumstances and interests of a party, it may result in early termination or renegotiation of the arrangement. The success of these transactions and arrangements will depend in part on our ability to leverage them to enhance our existing products and services or develop compelling new ones. It may take longer than expected to realize the full benefits from these transactions and arrangements, such as increased revenue, enhanced efficiencies, or increased market share, or the benefits may ultimately be smaller than we expected. These events could adversely affect our operating results or financial condition.

If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings. We acquire other companies and intangible assets and may not realize all the economic benefit from those acquisitions, which could cause an impairment of goodwill or intangibles. We review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in our stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in industry segments in which we participate. We may be required to record a significant charge on our consolidated financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively affecting our results of operations. For example, in the fourth quarter of fiscal year 2015, we recorded a $5.1 billion charge for the impairment of goodwill and a $2.2 billion charge for the impairment of intangible assets, and in the fourth quarter of fiscal year 2016 we recorded a $480 million charge for the impairment of intangible assets. The impairment charges for both periods related to our phone business. Our acquisition of LinkedIn resulted in a significant increase in our goodwill and intangible asset balances.

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

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

Protecting our intellectual property rights and combating unlicensed copying and use of our software and other intellectual property on a global basis is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual

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property rights. Our revenue in these markets may grow slower than the underlying device market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we educate users about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

We may not receive expected royalties from our patent licenses

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

Third parties may claim we infringe their intellectual property rights. From time to time, others claim we infringe their intellectual property rights. The number of these claims may grow because of constant technological change in the markets in which we compete, the extensive patent coverage of existing technologies, the rapid rate of issuance of new patents, and our offering of first-party devices, such as Surface 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, 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 to induce employees, users, partners, or customers to disclose sensitive information or take other actions to gain access to our data or our users' or customers' data, 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 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.

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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

The Security of our products and services is important in our customers' decisions to purchase or use our products or services. Security threats are a 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. Hackers that acquire user account information at other companies can use that information to compromise our users' accounts where accounts share the same attributes like passwords.

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 result in liability and harm our reputation. As we continue to grow the number and scale of our cloud-based offerings, we store and process increasingly large amounts of personally identifiable information of our customers. 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 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, Microsoft Azure, Microsoft Account services, Office 365, OneDrive, SharePoint Online, Skype, Xbox Live, Outlook.com, and Windows Stores. 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

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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, regulatory actions, 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. Flagship product releases such as Windows 10 can receive significant scrutiny under competition laws. For example, 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.

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. Specifically, we have been cooperating with authorities in the U.S. in connection with reports concerning our compliance with the Foreign Corrupt Practices Act in various countries. While we devote substantial resources to our global compliance programs and have implemented policies,

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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. Data protection authorities may assert that our collection, use, and management of customer data is inconsistent with their laws and regulations. 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, the EU and the U.S. formally entered into a new framework in July 2016 that provides a mechanism for companies to transfer data from EU member states to the U.S. This new framework, called the Privacy Shield, is intended to address shortcomings identified by the European Court of Justice in a predecessor mechanism. The Privacy Shield and other mechanisms are likely to be reviewed by the European courts, which may lead to uncertainty about the legal basis for data transfers across the Atlantic. In 2016 the EU adopted a new law governing data practices and privacy called the General Data Protection Regulation ("GDPR"), which becomes effective in May 2018. The law requires firms to meet new requirements regarding the handling of personal data. Engineering efforts to build new capabilities to facilitate compliance with the law may entail substantial expense and the diversion of engineering resources from other projects. If we are unable to engineer products that meet Microsoft's legal duties or help our customers meet their obligations under the GDPR or other data regulations, we might experience reduced demand for our offerings. Non-compliance with the GDPR may result in monetary penalties of up to 4% of worldwide turnover.

Ongoing legal reviews by regulators 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. Changes to U.S. immigration policies that restrain the flow of technical and professional talent may inhibit our ability to adequately staff our research and development efforts. 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. How employment-related laws are interpreted and applied to our workforce practices may result in increased operating costs and less flexibility in how we meet our workforce needs.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. These claims may arise from a wide variety of business practices and initiatives, including major new product releases such as Windows 10, significant business transactions, warranty or product claims, and employment practices. 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.

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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 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 as a result of recalls, safety alerts, or product liability claims if we fail to prevent, 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.

We strive to empower all people and organizations to achieve more, and accessibility of our products is an important aspect of this goal. There is increasing pressure from advocacy groups, regulators, competitors, and customers to make technology more accessible. If our products do not meet customer expectations or emerging global accessibility requirements, we could lose sales opportunities or face regulatory actions.

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. Emerging nationalist trends in specific countries may significantly alter the trade environment. Changes to trade policy or agreements may result in higher tariffs, local sourcing initiatives, or other developments that make it more difficult to sell our products in foreign countries. Any of these changes may negatively impact our revenues.

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.

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.

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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, 2016 – October 31, 2016	20,210,426	$58.39	20,210,426	$ 2,353
November 1, 2016 – November 30, 2016	20,319,000	$59.88	20,319,000	$ 1,136
December 1, 2016 – December 31, 2016	18,358,931	$61.89	18,358,931	$ 40,000
	58,888,357		58,888,357	

During the three months ended December 31, 2016, we repurchased 59 million shares of our common stock for $3.5 billion under a $40.0 billion share repurchase plan approved by our Board of Directors on September 16, 2013. This share repurchase program became effective on October 1, 2013, and was completed on December 22, 2016. All repurchases were made using cash resources.

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2016, no shares had been repurchased under this $40.0 billion share repurchase program.

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

3.1	Amended and Restated Articles of Incorporation of Microsoft Corporation (incorporated by reference to Form 8-K filed December 1, 2016)
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.

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 26, 2017

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