

MICROSOFT CORP
Form 10-Q
January 31, 2018

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, 2017

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period From to

Commission File Number: 001-37845

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

Washington
(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

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(Registrant’s telephone number, including area code)

None

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

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

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

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

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

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

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

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

Class	Outstanding as of January 26, 2018
Common Stock, \$0.00000625 par value per share	7,699,792,852 shares

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2017

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended		Six Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2017	2016	2017	2016
Revenue:				
Product	\$ 17,926	\$ 18,273	\$ 32,224	\$ 33,241
Service and other	10,992	7,553	21,232	14,513
Total revenue	28,918	25,826	53,456	47,754
Cost of revenue:				
Product	5,498	5,378	8,478	8,959
Service and other	5,566	4,523	10,864	8,786
Total cost of revenue	11,064	9,901	19,342	17,745
Gross margin	17,854	15,925	34,114	30,009
Research and development	3,504	3,062	7,078	6,168
Sales and marketing	4,562	4,079	8,374	7,297
General and administrative	1,109	879	2,275	1,924
Operating income	8,679	7,905	16,387	14,620
Other income, net	490	117	766	229
Income before income taxes	9,169	8,022	17,153	14,849
Provision for income taxes	15,471	1,755	16,879	2,915
Net income (loss)	\$(6,302)	\$ 6,267	\$ 274	\$ 11,934

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Earnings (loss) per share:				
Basic	\$ (0.82)	\$ 0.81	\$ 0.04	\$ 1.54
Diluted	\$ (0.82)	\$ 0.80	\$ 0.04	\$ 1.52
Weighted average shares outstanding:				
Basic	7,710	7,755	7,709	7,772
Diluted	7,710	7,830	7,799	7,853
Cash dividends declared per common share				
	\$ 0.42	\$ 0.39	\$ 0.84	\$ 0.78

Refer to accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
Net income (loss)	\$ (6,302)	\$ 6,267	\$ 274	\$ 11,934
Other comprehensive income (loss), net of tax:				
Net change related to derivatives	(7)	280	(113)	243
Net change related to investments	(878)	(994)	(1,166)	(911)
Translation adjustments and other	(40)	(592)	253	(474)
Other comprehensive loss	(925)	(1,306)	(1,026)	(1,142)
Comprehensive income (loss)	\$ (7,227)	\$ 4,961	\$ (752)	\$ 10,792

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

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BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2017	June 30, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 12,859	\$ 7,663
Short-term investments (including securities loaned of \$4,247 and \$3,694)	129,921	125,318
Total cash, cash equivalents, and short-term investments	142,780	132,981
Accounts receivable, net of allowance for doubtful accounts of \$337 and \$345	18,428	22,431
Inventories	2,003	2,181
Other	4,422	5,103
Total current assets	167,633	162,696
Property and equipment, net of accumulated depreciation of \$26,849 and \$24,179	26,304	23,734
Operating lease right-of-use assets	6,749	6,555
Equity and other investments	3,961	6,023
Goodwill	35,355	35,122
Intangible assets, net	9,034	10,106
Other long-term assets	6,967	6,076
Total assets	\$ 256,003	\$ 250,312
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 7,850	\$ 7,390
Short-term debt	12,466	9,072
Current portion of long-term debt	3,446	1,049
Accrued compensation	4,427	5,819
Short-term income taxes	788	718
Short-term unearned revenue	21,309	24,013
Securities lending payable	26	97
Other	7,787	7,587

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Total current liabilities	58,099	55,745
Long-term debt	73,348	76,073
Long-term income taxes	30,050	13,485
Long-term unearned revenue	2,500	2,643
Deferred income taxes	3,186	5,734
Operating lease liabilities	5,640	5,372
Other long-term liabilities	4,820	3,549
Total liabilities	177,643	162,601
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 7,705 and 7,708	70,192	69,315
Retained earnings	8,567	17,769
Accumulated other comprehensive income (loss)	(399)	627
Total stockholders' equity	78,360	87,711
Total liabilities and stockholders' equity	\$256,003	\$250,312

Refer to accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016
Operations				
Net income (loss)	\$(6,302)	\$6,267	\$274	\$11,934
Adjustments to reconcile net income (loss) to net cash from operations:				
Depreciation, amortization, and other	2,536	2,166	5,035	3,982
Stock-based compensation expense	986	767	1,959	1,470
Net recognized gains on investments and derivatives	(684)	(652)	(1,207)	(963)
Deferred income taxes	(2,305)	5	(2,358)	545
Changes in operating assets and liabilities:				
Accounts receivable	(3,908)	(2,789)	4,041	4,398
Inventories	1,205	1,132	182	265
Other current assets	354	1,300	36	335
Other long-term assets	(344)	(200)	(622)	(293)
Accounts payable	938	99	531	(344)
Unearned revenue	(1,065)	(1,077)	(2,871)	(2,884)
Income taxes	15,974	843	16,635	1,407
Other current liabilities	643	(1,267)	(1,521)	(1,727)
Other long-term liabilities	(153)	(301)	201	(283)
Net cash from operations	7,875	6,293	20,315	17,842
Financing				
Proceeds from issuance (repayments) of short-term debt, maturities of 90 days or less, net	3,759	(3,755)	49	(7,145)
Proceeds from issuance of debt	3,229	17,069	7,183	42,046
Repayments of debt	(3,327)	(4,118)	(4,496)	(4,343)
Common stock issued	189	131	496	372
Common stock repurchased	(2,008)	(3,599)	(4,578)	(7,961)
Common stock cash dividends paid	(3,238)	(3,024)	(6,241)	(5,824)
Other, net	(156)	312	(306)	200
Net cash from (used in) financing	(1,552)	3,016	(7,893)	17,345

Investing

Additions to property and equipment	(2,586)	(1,988)	(4,718)	(4,151)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(27)	(24,760)	(206)	(24,784)
Purchases of investments	(45,154)	(46,775)	(78,115)	(103,956)
Maturities of investments	6,352	8,715	11,578	17,374
Sales of investments	41,261	48,987	64,297	81,310
Securities lending payable	(177)	1,070	(71)	986
Net cash used in investing	(331)	(14,751)	(7,235)	(33,221)
Effect of foreign exchange rates on cash and cash equivalents	(17)	(18)	9	(8)
Net change in cash and cash equivalents	5,975	(5,460)	5,196	1,958
Cash and cash equivalents, beginning of period	6,884	13,928	7,663	6,510
Cash and cash equivalents, end of period	\$12,859	\$8,468	\$12,859	\$8,468

Refer to accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016
Common stock and paid-in capital				
Balance, beginning of period	\$ 69,419	\$ 67,747	\$ 69,315	\$ 68,178
Common stock issued	189	131	496	372
Common stock repurchased	(402)	(561)	(1,577)	(1,935)
Stock-based compensation expense	986	767	1,959	1,470
Other, net	0	93	(1)	92
Balance, end of period	70,192	68,177	70,192	68,177
Retained earnings				
Balance, beginning of period	19,702	12,757	17,769	13,118
Net income (loss)	(6,302)	6,267	274	11,934
Common stock cash dividends	(3,232)	(3,003)	(6,471)	(6,028)
Common stock repurchased	(1,601)	(3,021)	(3,005)	(6,024)
Balance, end of period	8,567	13,000	8,567	13,000
Accumulated other comprehensive income (loss)				
Balance, beginning of period	526	1,958	627	1,794
Other comprehensive loss	(925)	(1,306)	(1,026)	(1,142)
Balance, end of period	(399)	652	(399)	652
Total stockholders' equity	\$ 78,360	\$ 81,829	\$ 78,360	\$ 81,829

Refer to accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 — ACCOUNTING POLICIES

Accounting Principles

Our unaudited interim consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair presentation of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2017 Form 10-K filed with the U.S. Securities and Exchange Commission on August 2, 2017.

Principles of Consolidation

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

Estimates and Assumptions

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples of estimates and assumptions include: for revenue recognition, determining the nature and timing of satisfaction of performance obligations, and determining the standalone selling price (“SSP”) of performance obligations, variable consideration, and other obligations such as product returns and refunds; loss contingencies; product warranties; the fair value of and/or potential impairment of goodwill and intangible assets for our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; the market value of, and demand for, our inventory; stock-based compensation forfeiture rates; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized on our consolidated financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management’s estimates and assumptions.

Revenue

Product Revenue and Service and Other Revenue

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

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

Revenue Recognition

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

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Nature of Products and Services

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

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

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

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

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

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

Significant Judgments

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. When a cloud-based service includes both on-premises software licenses and cloud services, judgment is required to determine whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time. Certain cloud services, primarily Office 365, depend on a significant level of integration,

interdependency, and interrelation between the desktop applications and cloud services, and are accounted for together as one performance obligation. Revenue from Office 365 is recognized ratably over the period in which the cloud services are provided.

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

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

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

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Our products are generally sold with a right of return and we may provide other credits or incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize. Returns and credits are estimated at contract inception and updated at the end of each reporting period as additional information becomes available.

Contract Balances

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

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

As of December 31, 2017 and June 30, 2017, long-term accounts receivable, net of allowance for doubtful accounts, were \$1.6 billion and \$1.7 billion, respectively, and are included in other long-term assets on our consolidated balance sheets.

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

Activity in the allowance for doubtful accounts was as follows:

(In millions)

Six Months Ended December 31, 2017

Balance, beginning of period	\$361
Charged to costs and other	45
Write-offs	(53)

Balance, end of period	\$353
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Reported as of December 31, 2017

Accounts receivable, net of allowance for doubtful accounts	\$337
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Other long-term assets	16
Total	\$353

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

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

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

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Assets Recognized from Costs to Obtain a Contract with a Customer

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

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

Leases

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

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

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

Recent Tax Legislation

On December 22, 2017, the Tax Cuts and Jobs Act (“TCJA”) was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business. Refer to Note 12 – Income Taxes for further discussion.

As a result of the TCJA, we have recast certain prior period income tax liabilities on our consolidated balance sheets to conform to the current period presentation. Previously reported balances were impacted as follows:

(In millions)	As	As	As	As
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	Previously Reported	Adjusted	Previously Reported	Adjusted
		June 30, 2017		September 30, 2017
Balance Sheets				
Long-term income taxes	\$ 0	\$13,485	\$ 0	\$ 13,944
Other long-term liabilities	17,034	3,549	18,173	4,229

These adjustments had no impact on our consolidated income statements or net cash from or used in operating, financing, or investing on our consolidated cash flows statements.

Recent Accounting Guidance

Recently Adopted Accounting Guidance

Leases

In February 2016, the Financial Accounting Standards Board (“FASB”) issued a new standard related to leases to increase transparency and comparability among organizations by requiring the recognition of ROU assets and lease liabilities on the balance sheet. Most prominent among the changes in the standard is the recognition of ROU assets

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and lease liabilities by lessees for those leases classified as operating leases. Under the standard, disclosures are required to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We are also required to recognize and measure leases existing at, or entered into after, the beginning of the earliest comparative period presented using a modified retrospective approach, with certain practical expedients available.

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

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

Revenue from Contracts with Customers

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

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

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

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

standard on our consolidated financial statements.

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Impacts to Previously Reported Results

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

	As	New Revenue Standard	As
(In millions, except per share amounts)	Previously Reported	Adjustment	Restated

Income Statements

Three Months Ended December 31, 2016

Revenue	\$ 24,090	\$ 1,736	\$25,826
Provision for income taxes	1,163	592	1,755
Net income	5,200	1,067	6,267
Diluted earnings per share	0.66	0.14	0.80

Six Months Ended December 31, 2016

Revenue	\$ 44,543	\$ 3,211	\$47,754
Provision for income taxes	1,798	1,117	2,915
Net income	9,890	2,044	11,934
Diluted earnings per share	1.26	0.26	1.52

	As	New Revenue Standard	New Lease Standard	As
(In millions)	Previously Reported	Adjustment	Adjustment	Restated

Balance Sheets

June 30, 2017

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

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

Recent Accounting Guidance Not Yet Adopted

Financial Instruments – Targeted Improvements to Accounting for Hedging Activities

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

Accounting for Income Taxes – Intra-Entity Asset Transfers

In October 2016, the FASB issued new guidance requiring an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than when the asset has been sold to an outside party. This guidance is effective for us beginning July 1, 2018, with early adoption permitted beginning July 1, 2017. We plan to adopt the guidance effective July 1, 2018. Adoption of the guidance will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. A cumulative-effect adjustment will capture the write-off of income tax consequences deferred

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from past intra-entity transfers involving assets other than inventory and new deferred tax assets for amounts not recognized under current GAAP. As a result of the TCJA, we are currently re-evaluating the impact of this standard on our consolidated financial statements, including accounting policies, processes, and systems.

Financial Instruments – Credit Losses

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

Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

In January 2016, the FASB issued a new standard related to certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the changes in the standard is the requirement for changes in the fair value of our equity investments, with certain exceptions, to be recognized through net income rather than other comprehensive income (“OCI”). Under the standard, equity investments that do not have a readily determinable fair value are eligible for the measurement alternative. Using the measurement alternative, investments without readily determinable fair values will be valued at cost, with adjustments to fair value for changes in price or impairments reflected through net income.

The standard will be effective for us beginning July 1, 2018. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment from accumulated other comprehensive income (“AOCI”) to retained earnings as of the effective date. A cumulative-effect adjustment will capture any previously held unrealized gains and losses held in AOCI related to our equity investments carried at fair value as well as the impact of recording the fair value of certain equity investments carried at cost. The remaining implementation matters include establishing processes and controls around equity securities without readily determinable fair values and evaluating the impact of the standard to our accounting policies and disclosures. We expect to elect the measurement alternative for equity investments that do not have readily determinable fair values.

The impact on our consolidated balance sheets upon adoption will depend on the unrealized gains and losses held in AOCI related to our equity investments on the date of adoption, and on any impact the new guidance may have on our equity investments carried at cost. See Note 4 – Investments for our current investment balances. The impact of the standard going forward on our consolidated income statement will be dependent on our equity investment holdings, with adjustments to fair value reflected through net income. Adoption of the standard is expected to have no impact to cash from or used in operating, financing or investing on our consolidated cash flows statements.

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NOTE 2 — EARNINGS PER SHARE

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

The components of basic and diluted EPS were as follows:

(In millions, except per share amounts)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016
Net income (loss) available for common shareholders (A)	\$ (6,302)	\$ 6,267	\$274	\$11,934
Weighted average outstanding shares of common stock (B)	7,710	7,755	7,709	7,772
Dilutive effect of stock-based awards	0	75	90	81
Common stock and common stock equivalents (C)	7,710	7,830	7,799	7,853
Earnings (Loss) Per Share				
Basic (A/B)	\$ (0.82)	\$ 0.81	\$0.04	\$1.54
Diluted (A/C)	\$ (0.82)	\$ 0.80	\$0.04	\$1.52

Anti-dilutive stock-based awards excluded from the calculations of diluted EPS were immaterial during the periods presented. In periods where we recognized a net loss, we excluded the impact of potentially dilutive outstanding stock-based awards from the calculation of diluted loss per share as their inclusion would have an antidilutive effect.

NOTE 3 — OTHER INCOME (EXPENSE), NET

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

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(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016
Dividends and interest income	\$ 530	\$ 311	\$ 1,003	\$ 604
Interest expense	(698)	(521)	(1,370)	(958)
Net recognized gains on investments	768	698	1,341	1,103
Net losses on derivatives	(84)	(46)	(134)	(140)
Net losses on foreign currency remeasurements	(60)	(153)	(69)	(193)
Other, net	34	(172)	(5)	(187)
Total	\$ 490	\$ 117	\$ 766	\$ 229

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

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016
Other-than-temporary impairments of investments	\$ (24)	\$ (21)	\$ (30)	\$ (39)
Realized gains from sales of available-for-sale securities	1,066	851	1,737	1,334
Realized losses from sales of available-for-sale securities	(274)	(132)	(366)	(192)
Total	\$ 768	\$ 698	\$ 1,341	\$ 1,103

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NOTE 4 — INVESTMENTS

Investment Components

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

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash	Equity	
					and Cash	Short-term	and Other
					Equivalents	Investments	Investments
December 31, 2017							
Cash	\$3,877	\$0	\$0	\$3,877	\$3,877	\$0	\$0
Mutual funds	1,080	0	0	1,080	1,080	0	0
Commercial paper	1,533	0	0	1,533	904	629	0
Certificates of deposit	1,832	0	0	1,832	1,642	190	0
U.S. government and agency securities	119,085	34	(746)	118,373	4,465	113,908	0
Foreign government bonds	6,605	2	(12)	6,595	891	5,704	0
Mortgage- and asset-backed securities	3,952	7	(7)	3,952	0	3,952	0
Corporate notes and bonds	5,172	48	(14)	5,206	0	5,206	0
Municipal securities	284	47	0	331	0	331	0
Common and preferred stock	1,697	1,707	(6)	3,398	0	0	3,398
Other investments	564	0	0	564	0	1	563
Total	\$ 145,681	\$ 1,845	\$ (785)	\$ 146,741	\$ 12,859	\$ 129,921	\$ 3,961

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

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June 30, 2017

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

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As of December 31, 2017 and June 30, 2017, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were \$1.0 billion and \$1.1 billion, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

We lend certain fixed-income and equity securities to increase investment returns. These transactions are accounted for as secured borrowings and the loaned securities continue to be carried as investments on our consolidated balance sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. As of December 31, 2017 and June 30, 2017, collateral received under agreements for loaned securities was \$4.3 billion and \$3.7 billion, respectively, and was primarily comprised of U.S. government and agency securities.

Unrealized Losses on Investments

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

(In millions)	Less than 12 Months		12 Months or Greater		Total Fair Value	Total Unrealized Losses
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		
December 31, 2017						
U.S. government and agency securities	\$101,552	\$(672)	\$2,855	\$(74)	\$104,407	\$(746)
Foreign government bonds	2,537	(1)	34	(11)	2,571	(12)
Mortgage- and asset-backed securities	1,317	(3)	338	(4)	1,655	(7)
Corporate notes and bonds	1,118	(6)	439	(8)	1,557	(14)
Common and preferred stock	17	0	36	(6)	53	(6)
Total	\$106,541	\$ (682)	\$ 3,702	\$ (103)	\$ 110,243	\$ (785)

Less than 12 Months 12 Months or Greater

Total
Unrealized
Losses 32

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

Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from domestic and international equities are due to market price movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence.

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Debt Investment Maturities

(In millions)	Estimated	
	Cost Basis	Fair Value
December 31, 2017		
Due in one year or less	\$ 19,448	\$ 19,447
Due after one year through five years	103,950	103,341
Due after five years through 10 years	14,143	14,083
Due after 10 years	922	951
Total	\$ 138,463	\$ 137,822

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, 2017 and June 30, 2017, the total notional amounts of these foreign exchange contracts sold were \$7.5 billion and \$8.9 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, 2017 and June 30, 2017, the total notional amounts of these foreign exchange contracts sold were \$5.6 billion and \$5.1 billion, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures. As of December 31, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were \$8.9 billion and \$10.4 billion, respectively. As of June 30, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were \$8.8 billion and \$10.6 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of December 31, 2017, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$1.5 billion and \$1.9 billion, respectively, of which \$1.4 billion and \$1.6 billion, respectively, were designated as hedging instruments. As of June 30, 2017, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$1.9 billion and \$2.4 billion, respectively, of which \$1.6 billion and \$1.8 billion, respectively, were designated as hedging instruments.

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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, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were \$584 million and \$377 million, respectively. As of June 30, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were \$233 million and \$352 million, respectively.

In addition, we use “To Be Announced” forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of December 31, 2017 and June 30, 2017, the total notional derivative amounts of mortgage contracts purchased were \$542 million and \$567 million, respectively.

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low-cost method of managing exposure to individual credit risks or groups of credit risks. As of December 31, 2017, the total notional amounts of credit contracts purchased and sold were \$240 million and \$48 million, respectively. As of June 30, 2017, the total notional amounts of credit contracts purchased and sold were \$267 million and \$63 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain minimum liquidity of \$1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of December 31, 2017, our long-term unsecured debt rating was AAA, and cash investments were in excess of \$1.0 billion. As a result, no collateral was required to be posted.

Fair Values of Derivative Instruments

Derivative instruments are recognized as either assets or liabilities and are measured at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

For derivative instruments designated as fair value hedges, the gains (losses) are recognized in earnings in the periods of change together with the offsetting (losses) gains on the hedged items attributed to the risk being hedged. For options designated as fair value hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings.

For derivative instruments designated as cash flow hedges, the effective portion of the gains (losses) on the derivatives is initially reported as a component of OCI and is subsequently recognized in earnings when the hedged exposure is recognized in earnings. For options designated as cash flow hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings. Gains (losses) on derivatives representing either hedge components excluded from the assessment of effectiveness or hedge ineffectiveness are recognized in earnings.

For derivative instruments that are not designated as hedges, gains (losses) from changes in fair values are primarily recognized in other income (expense), net. Other than those derivatives entered into for investment purposes, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are reclassified from 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:

(In millions)	Assets			Liabilities		
	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Long-term Assets	Other Current Liabilities	Other Long-term Liabilities
December 31, 2017						
Non-designated Hedge Derivatives						
Foreign exchange contracts	\$5	\$145	\$0	\$32	\$(165)	\$(5)
Equity contracts	7	0	0	0	(1)	0
Interest rate contracts	4	0	0	0	(5)	0
Credit contracts	3	0	0	0	(1)	0
Total	\$19	\$145	\$0	\$32	\$(172)	\$(5)
Designated Hedge Derivatives						
Foreign exchange contracts	\$10	\$48	\$0	\$3	\$(27)	\$(5)
Equity contracts	0	0	7	0	(328)	0
Total	\$10	\$48	\$7	\$3	\$(355)	\$(5)
Total gross amounts of derivatives	\$29	\$193	\$7	\$35	\$(527)	\$(10)
Gross derivatives either offset or subject to an enforceable master netting agreement	\$28	\$193	\$7	\$35	\$(526)	\$(10)
Gross amounts of derivatives offset on the balance sheet	(30)	(115)	(7)	(7)	152	7

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Net amounts presented on the balance sheet	(2)	78	0	28	(374)	(3)
Gross amounts of derivatives not offset on the balance sheet	0	0	0	0	0	0
Cash collateral received	0	0	0	0	(51)	0
Net amount	\$ (2)	\$78	\$ 0	\$ 28	\$ (425)	\$ (3)

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

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Cash collateral received	0	0	0	0	(228)	0
Net amount	\$80	\$204	\$ 0	\$ (2)	\$ (341)	\$ (1)

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

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Fair Value Hedge Gains (Losses)

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

(In millions)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016

Foreign Exchange Contracts

Derivatives	\$ 14	\$ 685	\$ 36	\$ 637
Hedged items	12	(674)	10	(606)
Total amount of ineffectiveness	\$ 26	\$ 11	\$ 46	\$ 31

Equity Contracts

Derivatives	\$ (71)	\$ (7)	\$ (307)	\$ (17)
Hedged items	71	7	307	17
Total amount of ineffectiveness	\$ 0	\$ 0	\$ 0	\$ 0

Amount of equity contracts excluded from effectiveness assessment	\$ 20	\$ (1)	\$ 60	\$ (4)
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Cash Flow Hedge Gains (Losses)

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

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

	2017	2016	2017	2016
Effective Portion				
Gains recognized in other comprehensive income (loss) (net of tax of \$1, \$3, \$1, and \$4)	\$ 10	\$ 449	\$ 15	\$ 484
Gains reclassified from accumulated other comprehensive income (loss) into revenue	19	172	130	247
Amount Excluded from Effectiveness Assessment and Ineffective Portion				
Losses recognized in other income (expense), net	(73)	(84)	(164)	(154)

We estimate that \$22 million of net derivative gains included in AOCI as of December 31, 2017 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during the three and six months ended December 31, 2017.

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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, 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		Six Months Ended	
	December 31,		December 31,	
	2017	2016	2017	2016
Foreign exchange contracts	\$ (115)	\$ 26	\$ (184)	\$ (5)
Equity contracts	(49)	(25)	(78)	(42)
Interest-rate contracts	(2)	(10)	9	(6)
Credit contracts	0	2	0	4
Other contracts	0	22	0	0
Total	\$ (166)	\$ 15	\$ (253)	\$ (49)

NOTE 6 — FAIR VALUE MEASUREMENTS

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

- Level 1 – inputs are based upon unadjusted quoted prices for identical instruments in active markets. Our Level 1 non-derivative investments primarily include U.S. government securities, domestic and international equities, and actively traded mutual funds. Our Level 1 derivative assets and liabilities include those actively traded on exchanges.
- Level 2 – inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves,

credit spreads, foreign exchange rates, and forward and spot prices for currencies. Our Level 2 non-derivative investments consist primarily of foreign government bonds, corporate notes and bonds, mortgage- and asset-backed securities, U.S. government and agency securities, certificates of deposit, and common and preferred stock. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.

Level 3 – inputs are generally unobservable and typically reflect management’s estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models. Our Level 3 non-derivative assets and liabilities primarily comprise investments in common and preferred stock, and goodwill and intangible assets, when they are recorded at fair value due to an impairment charge. Unobservable inputs used in the models are significant to the fair values of the assets and liabilities.

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

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

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

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

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	(a) Netting	Net Fair Value
December 31, 2017						
Assets						
Mutual funds	\$1,080	\$0	\$0	\$1,080	\$0	\$1,080
Commercial paper	0	1,533	0	1,533	0	1,533
Certificates of deposit	0	1,832	0	1,832	0	1,832
U.S. government and agency securities	116,194	2,180	0	118,374	0	118,374
Foreign government bonds	15	6,598	0	6,613	0	6,613
Mortgage- and asset-backed securities	0	3,953	0	3,953	0	3,953
Corporate notes and bonds	1	5,181	6	5,188	0	5,188
Municipal securities	0	331	0	331	0	331
Common and preferred stock	969	1,392	18	2,379	0	2,379
Derivatives	1	262	1	264	(159)	105
Total	\$ 118,260	\$23,262	\$25	\$141,547	\$(159)	\$141,388

Liabilities

Derivatives and other	\$3	\$534	\$37	\$574	\$(159)	\$415
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(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	(a) Netting	Net Fair Value
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June 30, 2017

Assets

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Mutual funds	\$1,478	\$0	\$0	\$1,478	\$0	\$1,478
Commercial paper	0	319	0	319	0	319
Certificates of deposit	0	1,358	0	1,358	0	1,358
U.S. government and agency securities	109,228	2,616	0	111,844	0	111,844
Foreign government bonds	0	5,187	0	5,187	0	5,187
Mortgage- and asset-backed securities	0	3,934	0	3,934	0	3,934
Corporate notes and bonds	0	4,829	1	4,830	0	4,830
Municipal securities	0	327	0	327	0	327
Common and preferred stock	2,414	1,994	18	4,426	0	4,426
Derivatives	1	508	0	509	(227)	282
Total	\$ 113,121	\$ 21,072	\$ 19	\$ 134,212	\$ (227)	\$ 133,985

Liabilities

Derivatives and other	\$0	\$345	\$39	\$384	\$(228)	\$156
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(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, 2017		June 30, 2017
Net fair value of assets measured at fair value on a recurring basis	\$ 141,388	\$ 133,985
Cash	3,877	3,624
Common and preferred stock measured at fair value on a nonrecurring basis	1,017	1,073
Other investments measured at fair value on a nonrecurring basis	564	523
Less derivative net assets classified as other current and long-term assets	(106)	(202)
Other	1	1
Recorded basis of investment components	\$ 146,741	\$ 139,004

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

During the three and six months ended December 31, 2017 and 2016, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 — INVENTORIES

The components of inventories were as follows:

(In millions)

December 31, 2017	June 30, 2017
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Raw materials	\$ 491	\$ 797
Work in process	91	145
Finished goods	1,421	1,239
Total	\$ 2,003	\$ 2,181

NOTE 8 — BUSINESS COMBINATIONS

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

NOTE 9 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30,		December 31,	
	2017	Acquisitions	Other	2017
Productivity and Business Processes	\$23,739	\$ 0	\$ 31	\$ 23,770
Intelligent Cloud	5,555	68	6	5,629
More Personal Computing	5,828	57	71	5,956
Total	\$35,122	\$ 125	\$ 108	\$ 35,355

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

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Any change in the goodwill amounts resulting from foreign currency translations and purchase accounting adjustments are presented as “Other” in the above table. Also included in “Other” are business dispositions and transfers between 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, 2017			June 30, 2017		
Technology-based ^(a)	\$7,126	\$ (4,334)	\$ 2,792	\$7,765	\$ (4,318)	\$3,447
Customer-related	4,022	(937)	3,085	4,045	(692)	3,353
Marketing-related	4,027	(958)	3,069	4,016	(829)	3,187
Contract-based	666	(578)	88	841	(722)	119
Total	\$ 15,841	\$ (6,807)	\$ 9,034	\$ 16,667	\$ (6,561)	\$ 10,106

(a) Technology-based intangible assets included \$32 million and \$59 million of net carrying amount of software to be sold, leased, or otherwise marketed as of December 31, 2017 and June 30, 2017, respectively.

Intangible assets amortization expense was \$562 million and \$1.1 billion for the three and six months ended December 31, 2017, respectively, and \$315 million and \$529 million for the three and six months ended December 31, 2016, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held as of December 31, 2017:

(In millions)

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Year Ending June 30,

2018 (excluding the six months ended December 31, 2017)	\$1,105
2019	1,700
2020	1,194
2021	1,005
2022	931
Thereafter	3,099
Total	\$9,034

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NOTE 11 — DEBT

Short-term Debt

As of December 31, 2017, we had \$12.5 billion of commercial paper issued and outstanding, with a weighted average interest rate of 1.31% and maturities ranging from 22 days to 196 days. As of June 30, 2017, we had \$9.1 billion of commercial paper issued and outstanding, with a weighted average interest rate of 1.01% and maturities ranging from 25 days to 264 days. The estimated fair value of this commercial paper approximates its carrying value.

In October 2017, we entered into two new \$5.0 billion credit facilities that expire on October 30, 2018 and October 31, 2022, respectively, which replaced our previous credit facilities. These credit facilities serve as a back-up for our commercial paper program. As of December 31, 2017, we were in compliance with the only financial covenant in both credit agreements, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreements. No amounts were drawn against these credit facilities during any of the periods presented.

Long-term Debt

As of December 31, 2017, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$76.8 billion and \$81.7 billion, respectively. As of June 30, 2017, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$77.1 billion and \$80.3 billion, respectively. These estimated fair values are based on Level 2 inputs.

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

	Face Value December 31,	Face Value June 30,	Stated Interest Rate	Effective Interest Rate
(In millions, except interest rates)	2017	2017	Rate	Rate
Notes				
November 15, 2017	\$ 0	\$ 600	0.875%	1.084%
May 1, 2018	450	450	1.000%	1.106%
November 3, 2018	1,750	1,750	1.300%	1.396%
December 6, 2018	1,250	1,250	1.625%	1.824%
June 1, 2019	1,000	1,000	4.200%	4.379%
August 8, 2019				
	2,500	2,500	1.100%	1.203%
November 1, 2019				
	18	18	0.500%	0.500%
February 6, 2020				
	1,500	1,500	1.850%	1.952%
February 12, 2020	1,500	1,500	1.850%	1.935%
October 1, 2020	1,000	1,000	3.000%	3.137%
November 3, 2020	2,250	2,250	2.000%	2.093%
February 8, 2021	500	500	4.000%	4.082%
August 8, 2021				
	2,750	2,750	1.550%	1.642%
December 6, 2021 ^(a)				
	2,102	1,996	2.125%	2.233%
February 6, 2022				
	1,750	1,750	2.400%	2.520%
February 12, 2022	1,500	1,500	2.375%	2.466%
November 3, 2022	1,000	1,000	2.650%	2.717%
November 15, 2022	750	750	2.125%	2.239%
May 1, 2023	1,000	1,000	2.375%	2.465%

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August 8, 2023

	1,500	1,500	2.000%	2.101%
December 15, 2023	1,500	1,500	3.625%	3.726%
February 6, 2024				
	2,250	2,250	2.875%	3.041%
February 12, 2025	2,250	2,250	2.700%	2.772%
November 3, 2025	3,000	3,000	3.125%	3.176%
August 8, 2026				
	4,000	4,000	2.400%	2.464%
February 6, 2027				
	4,000	4,000	3.300%	3.383%
December 6, 2028 ^(a)				
	2,102	1,996	3.125%	3.218%
May 2, 2033 ^(a)				
	660	627	2.625%	2.690%
February 12, 2035	1,500	1,500	3.500%	3.604%
November 3, 2035	1,000	1,000	4.200%	4.260%
August 8, 2036	2,250	2,250		