MICROSOFT CORP
Form 10-Q
January 22, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended December 31, 2008

OR

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

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

(425) 882-8080

(Registrant s telephone number, including area code)

None

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

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

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

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

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

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

Class	**Outstanding at January 20, 2009**
Common Stock, $0.00000625 par value per share	8,890,562,873 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2008

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

INCOME STATEMENTS

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	**2007**	**2008**	**2007**
Revenue	**$ 16,629**	$ 16,367	**$ 31,690**	$ 30,129
Operating expenses:				
Cost of revenue	**3,907**	3,543	**6,755**	6,218
Research and development	**2,290**	1,885	**4,573**	3,722
Sales and marketing	**3,662**	3,420	**6,706**	6,103
General and administrative	**831**	1,066	**1,718**	1,784
Total operating expenses	**10,690**	9,914	**19,752**	17,827
Operating income	**5,939**	6,453	**11,938**	12,302
Other income (expense)	**(301)**	367	**(309)**	734
Income before income taxes	**5,638**	6,820	**11,629**	13,036
Provision for income taxes	**1,464**	2,113	**3,082**	4,040
Net income	**$ 4,174**	$ 4,707	**$ 8,547**	$ 8,996
Earnings per share:				
Basic	**$ 0.47**	$ 0.50	**$ 0.95**	$ 0.96
Diluted	**$ 0.47**	$ 0.50	**$ 0.94**	$ 0.95
Weighted average shares outstanding:				
Basic	**8,903**	9,361	**8,994**	9,370
Diluted	**8,914**	9,503	**9,052**	9,519
Cash dividends declared per common share	**$ 0.13**	$ 0.11	**$ 0.26**	$ 0.22

See accompanying notes.

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MICROSOFT CORPORATION

BALANCE SHEETS

(In millions)

	December 31, 2008 (Unaudited)	June 30, 2008(1)
Assets		
Current assets:		
Cash and cash equivalents	**$ 8,346**	$ 10,339
Short-term investments (including securities pledged as collateral of $417 and $2,491)	**12,369**	13,323
Total cash, cash equivalents, and short-term investments	**20,715**	23,662
Accounts receivable, net of allowance for doubtful accounts of $254 and $153	**10,953**	13,589
Inventories	**968**	985
Deferred income taxes	**1,504**	2,017
Other	**3,590**	2,989
Total current assets	**37,730**	43,242
Property and equipment, net of accumulated depreciation of $6,959 and $6,302	**6,996**	6,242
Equity and other investments	**3,922**	6,588
Goodwill	**12,490**	12,108
Intangible assets, net	**1,815**	1,973
Deferred income taxes	**1,109**	949
Other long-term assets	**1,724**	1,691
Total assets	**$ 65,786**	$ 72,793
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,533**	$ 4,034
Short-term debt	**2,000**	
Accrued compensation	**2,239**	2,934
Income taxes	**848**	3,248
Short-term unearned revenue	**11,532**	13,397
Securities lending payable	**469**	2,614
Other	**3,089**	3,659
Total current liabilities	**23,710**	29,886
Long-term unearned revenue	**1,534**	1,900
Other long-term liabilities	**6,064**	4,721
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding 8,889 and 9,151	**61,392**	62,849
Retained deficit, including accumulated other comprehensive income of $585 and $1,140	**(26,914)**	(26,563)
Total stockholders equity	**34,478**	36,286
Total liabilities and stockholders equity	**$ 65,786**	$ 72,793

(1) Derived from audited financial statements.

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions)(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	**2007**	**2008**	**2007**
Operations				
Net income	**$ 4,174**	$ 4,707	**$ 8,547**	$ 8,996
Depreciation, amortization, and other noncash items	**632**	481	**1,217**	916
Stock-based compensation expense	**417**	360	**860**	693
Net recognized losses (gains) on investments and derivatives	**139**	(134)	**175**	(321)
Excess tax benefits from stock-based payment arrangements	**(2)**	(33)	**(46)**	(102)
Deferred income taxes	**454**	323	**830**	680
Unearned revenue	**5,969**	5,995	**10,155**	9,816
Recognition of unearned revenue	**(6,364)**	(5,368)	**(12,408)**	(10,333)
Accounts receivable	**(1,647)**	(2,586)	**2,338**	220
Other current assets	**797**	445	**239**	210
Other long-term assets	**(69)**	(55)	**(185)**	(66)
Other current liabilities	**614**	325	**(3,938)**	(864)
Other long-term liabilities	**668**	107	**1,368**	600
Net cash from operations	**5,782**	4,567	**9,152**	10,445
Financing				
Net proceeds from short-term debt	**21**		**1,996**	
Common stock issued	**96**	2,335	**324**	2,981
Common stock repurchased	**(2,820)**	(4,057)	**(9,313)**	(6,987)
Common stock cash dividends	**(1,157)**	(1,034)	**(2,155)**	(1,972)
Excess tax benefits from stock-based payment arrangements	**2**	33	**46**	102
Net cash used in financing	**(3,858)**	(2,723)	**(9,102)**	(5,876)
Investing				
Additions to property and equipment	**(842)**	(695)	**(1,620)**	(1,205)
Acquisition of companies, net of cash acquired	**(450)**	(433)	**(827)**	(5,829)
Purchases of investments	**(6,596)**	(6,317)	**(10,842)**	(12,314)
Maturities of investments	**290**	470	**754**	800
Sales of investments	**5,700**	6,696	**12,775**	15,816
Securities lending payable	**(601)**	(770)	**(2,144)**	(574)
Net cash used in investing	**(2,499)**	(1,049)	**(1,904)**	(3,306)
Effect of exchange rates on cash and cash equivalents	**(83)**	28	**(139)**	86
Net change in cash and cash equivalents	**(658)**	823	**(1,993)**	1,349
Cash and cash equivalents, beginning of period	**9,004**	6,637	**10,339**	6,111
Cash and cash equivalents, end of period	**$ 8,346**	$ 7,460	**$ 8,346**	$ 7,460

See accompanying notes.

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MICROSOFT CORPORATION

STOCKHOLDERS EQUITY STATEMENTS

(In millions)(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	**2007**	**2008**	**2007**
Common stock and paid-in capital				
Balance, beginning of period	**$ 61,655**	$ 60,699	**$ 62,849**	$ 60,557
Common stock issued	**86**	2,380	**312**	3,035
Common stock repurchased	**(674)**	(805)	**(2,571)**	(1,621)
Stock-based compensation expense	**417**	360	**860**	693
Stock option income tax deficiencies	**(91)**	(106)	**(58)**	(193)
Other, net	**(1)**			57
Balance, end of period	**61,392**	62,528	**61,392**	62,528
Retained deficit				
Balance, beginning of period	**(28,061)**	(28,564)	**(26,563)**	(29,460)
Cumulative effect of a change in accounting principle adoption of FIN 48				(395)
Cumulative effect of a change in accounting principle adoption of EITF 06-2				(17)
Net income	**4,174**	4,707	**8,547**	8,996
Other comprehensive income:				
Net gains on derivative instruments	**473**	137	**766**	49
Net unrealized investments losses	**(514)**	(78)	**(912)**	(164)
Translation adjustments and other	**(251)**	39	**(409)**	89
Comprehensive income	**3,882**	4,805	**7,992**	8,970
Common stock cash dividends	**(1,147)**	(1,031)	**(2,304)**	(2,060)
Common stock repurchased	**(1,588)**	(3,307)	**(6,039)**	(5,135)
Balance, end of period	**(26,914)**	(28,097)	**(26,914)**	(28,097)
Total stockholders equity	**$ 34,478**	$ 34,431	**$ 34,478**	$ 34,431

See accompanying notes.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

Note 1 Accounting Policies

Basis of Presentation

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

Effective July 1, 2008, we began presenting gains and losses resulting from foreign currency remeasurements as a component of other income (expense). Prior to July 1, 2008, we included gains and losses resulting from foreign currency remeasurements as a component of sales and marketing expense. We changed our presentation because this better reflects how we manage these foreign currency exposures, as such gains and losses arising from the remeasurement of foreign currency transactions are incidental to our operations. Prior period amounts have been recast to conform to the current period presentation. See Note 3 Other Income (Expense).

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 2008 Form 10-K and Form 8-K filed on November 20, 2008 with the U.S. Securities and Exchange Commission.

Basis of Consolidation

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

Goodwill

During the second quarter of fiscal year 2009, we changed the date of our annual impairment test from July 1 to May 1. During fiscal year 2009, the annual impairment test was performed as of July 1, 2008 and will be performed again as of May 1, 2009. The change was made to more closely align the impairment testing date with our long-range planning and forecasting process. We believe the resulting change in accounting principle related to changing the annual impairment testing date will not delay, accelerate, or avoid an impairment charge. We have determined that this change in accounting principle is preferable under the circumstances and does not result in adjustments to our financial statements when applied retrospectively. The impact of the new impairment testing date, if material,

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

will be disclosed in the fourth quarter of fiscal year 2009, which is the quarter in which the new testing date will occur.

Recently Adopted Accounting Pronouncements

On July 1, 2008, we adopted Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements* (SFAS No. 157) for all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. See Note 4 Financial Instruments.

Statement of Financial Accounting Standard (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115,* became effective for us on July 1, 2008. SFAS No. 159 gives us the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis with the difference between the carrying value before election of the fair value option and the fair value recorded upon election as an adjustment to beginning retained earnings. As of December 31, 2008, we had not elected the fair value option for any eligible financial asset or liability.

Recent Accounting Pronouncements Not Yet Adopted

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133,* which requires additional disclosures about the objectives of derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective for us beginning January 1, 2009. We believe the adoption of SFAS No. 161 will not have a material impact on our financial statements.

In February 2008, the FASB issued FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157,* which delays the effective date of SFAS No. 157 to July 1, 2009 for us, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We believe the adoption of the delayed items of SFAS No. 157 will not have a material impact on our financial statements.

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

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Note 2 Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and stock awards, some of which are performance-based.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
(In millions, except earnings per share)	**2008**	**2007**	**2008**	**2007**
Net income available for common shareholders (A)	**$ 4,174**	$ 4,707	**$ 8,547**	$ 8,996
Weighted average outstanding shares of common stock (B)	**8,903**	9,361	**8,994**	9,370
Dilutive effect of employee stock options and awards	**11**	142	**58**	149
Common stock and common stock equivalents (C)	**8,914**	9,503	**9,052**	9,519
Earnings per share:				
Basic (A/B)	**$ 0.47**	$ 0.50	**$ 0.95**	$ 0.96
Diluted (A/C)	**$ 0.47**	$ 0.50	**$ 0.94**	$ 0.95

The following shares attributable to outstanding equity awards were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive:

	Three Months Ended December 31,		Six Months Ended December 31,	
(In millions)	**2008**	**2007**	**2008**	**2007**
Shares excluded from calculation of diluted EPS	**517**	71	**326**	77

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3 Other Income (Expense)

Components of other income (expense) were as follows:

(In millions)	Three Months Ended December 31, 2008	Three Months Ended December 31, 2007	Six Months Ended December 31, 2008	Six Months Ended December 31, 2007
Dividends and interest	**$ 175**	$ 206	**$ 382**	$ 445
Net recognized gains on investments	**270**	87	**399**	238
Net gains (losses) on derivatives	**(409)**	48	**(574)**	84
Net gains (losses) on foreign currency remeasurements	**(350)**	23	**(529)**	103
Other	**13**	3	**13**	(136)
Total	**$ (301)**	$ 367	**$ (309)**	$ 734

Effective July 1, 2008, we began presenting gains and losses resulting from foreign currency remeasurements as a component of other income (expense). Prior to July 1, 2008, we included gains and losses resulting from foreign currency remeasurements as a component of sales and marketing expense. We changed our presentation because this better reflects how we manage these foreign currency exposures, as such gains and losses arising from the remeasurement of foreign currency transactions are incidental to our operations. For the three and six months ended December 31, 2008, losses of $350 million and $529 million, respectively, were reported as other income (expense). For the three and six months ended December 31, 2007, gains of $28 million and $97 million, respectively, were previously recorded as a component of sales and marketing expense and have been recast as other income (expense).

Other-than-temporary impairments, which are included in net recognized gains on investments, were $262 million during the three months and $334 million during the six months ended December 31, 2008, as compared with $54 million during the three months and $69 million during the six months ended December 31, 2007. Other-than-temporary impairments increased primarily due to declines in equity values as a result of continuing declines in equity markets. In evaluating when declines in fair value are other than temporary, we consider all available evidence, including market declines subsequent to the end of the period.

Note 4 Financial Instruments

We adopted SFAS No. 157 on July 1, 2008 for all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

SFAS No. 157 defines fair value as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk including our own credit risk.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

In addition to defining fair value, SFAS No. 157 expands the disclosure requirements around fair value and establishes a fair value hierarchy for valuation inputs. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by 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.

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 for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

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 that include option pricing models, discounted cash flow models, and similar techniques.

The following section describes the valuation methodologies we use to measure financial assets and liabilities at fair value.

Investments Other Than Derivatives

Investments other than derivatives primarily include U.S. government and agency securities, foreign government bonds, mortgage-backed securities, commercial paper, corporate notes and bonds, and common stock and equivalents.

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine fair value. This pricing methodology applies to our Level 1 investments such as domestic and international equities, U.S. treasuries, exchange-traded mutual funds, and agency 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. These investments are included in Level 2 and consist primarily of corporate notes and bonds, foreign government bonds, mortgage-backed securities, commercial paper, and certain agency securities. Our Level 3 assets primarily include investments in certain corporate bonds. We value the Level 3 corporate bonds using internally developed valuation models whose inputs include interest rate curves, credit spreads, stock prices, and volatilities. Unobservable inputs used in these models are significant to the fair value of the investments.

Derivatives

In general, and where applicable, we use quoted prices in an active market for identical derivative assets and liabilities that are traded on exchanges. These derivative assets and liabilities are included in Level 1. The fair values for the derivative assets and liabilities included in Level 2 are estimated using industry standard valuation models, such as the Black-Scholes model. 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, foreign exchange rates, and forward and spot

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

prices for currencies and commodities. Level 2 derivative assets and liabilities primarily include certain over-the-counter options, futures, and swap contracts. In certain cases, market-based observable inputs are not available and we use management judgment to develop assumptions to determine fair value. These derivative assets and liabilities are included in Level 3 and primarily represent derivatives for foreign equities and bonds.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents our assets and liabilities measured at fair value on a recurring basis at December 31, 2008:

(In millions)	Level 1	Level 2	Level 3	FIN39 netting(a)	Net balance
Assets					
Mutual funds	$ 1,122	$ 32	$	$	$ 1,154
Commercial paper		2,098			2,098
Certificates of deposit		398			398
U.S. government and agency securities	1,422	1,999			3,421
Foreign government bonds	337	2,985			3,322
Mortgage-backed securities		3,699			3,699
Corporate notes and bonds		2,743	121		2,864
Municipal securities		197			197
Common and preferred stock	3,126	11	2		3,139
Derivatives	32	1,317		(645)	704
Total	$ 6,039	$ 15,479	$ 123	$ (645)	$ 20,996
Liabilities					
Derivatives	$ 18	$ 918	$	$ (633)	$ 303
Total	$ 18	$ 918	$	$ (633)	$ 303

(a) FASB Interpretation 39, *Offsetting of Amounts Related to Certain Contracts an interpretation of APB No. 10 and FASB Statement No. 105*, permits the netting of derivative assets and derivative liabilities when a legally enforceable master netting agreement exists. These amounts include fair value adjustments related to our own credit risk and counterparty credit risk.

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MICROSOFT CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Unaudited)

Changes in Level 3 Instruments Measured at Fair Value on a Recurring Basis

The following table presents the changes in Level 3 instruments measured on a recurring basis for the three and six months ended December 31, 2008. The majority of our Level 3 instruments consist of investment securities classified as available-for-sale with changes in fair value included in other comprehensive income.

	Three Months Ended December 31, 2008			
(In millions)	**Corporate notes and bonds**	**Common stock and equivalents**	**Derivative assets**	**Total**
Balance, beginning of period	$ 111	$ 4	$ 15	$ 130
Total realized and unrealized gains (losses):				
Included in other income (expense)	**1**	**(2)**		**(1)**
Included in other comprehensive income	**10**			**10**
Purchases, issuances, and settlements			**(15)**	**(15)**
Transfers out	**(1)**			**(1)**
Balance, end of period	**$ 121**	**$ 2**	**$**	**$ 123**
Change in unrealized gains (losses) included in other income (expense) related to assets held as of December 31, 2008	**$**	**$ (2)**	**$**	**$ (2)**

	Six Months Ended December 31, 2008			
(In millions)	**Corporate notes and bonds**	**Common stock and equivalents**	**Derivative assets**	**Total**
Balance, beginning of period	$ 138	$ 8	$ 71	$ 217
Total realized and unrealized gains (losses):				
Included in other income (expense)	**(8)**	**(6)**	**48**	**34**
Included in other comprehensive income	**(19)**			**(19)**
Purchases, issuances, and settlements			**(119)**	**(119)**
Transfers in	**10**			**10**
Balance, end of period	**$ 121**	**$ 2**	**$**	**$ 123**
Change in unrealized gains (losses) included in other income (expense) related to assets held as of December 31, 2008	**$ (9)**	**$ (5)**	**$ 1**	**$ (13)**

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Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We measure certain assets, including our cost and equity method investments, at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. The table below sets out the balances for those assets required to be measured at fair value on a nonrecurring basis and the associated losses recognized during the three months ended December 31, 2008:

(In millions)	December 31, 2008	Level 1	Level 2	Level 3	Total losses
Assets					
Common and preferred stock	$ 164	$	$	$ 164	$ (85)
Total	$ 164	$	$	$ 164	$ (85)

In accordance with the provisions of APB No. 18, *The Equity Method of Accounting for Investments in Common Stock*, we review the carrying values of our investments when events and circumstances warrant and consider all available evidence in evaluating when declines in fair value are other than temporary. The fair values of our 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 is determined to be other than temporary. An impairment charge of $85 million was recorded for certain investments measured at fair value on a nonrecurring basis as the decline in their respective fair values below their cost was determined to be other than temporary in all instances.

Note 5 Inventories

Components of inventories were as follows:

(In millions)	December 31, 2008	June 30, 2008
Raw materials	$ 263	$ 417
Work in process	57	31
Finished goods	648	537
Total	$ 968	$ 985

Note 6 Acquisitions

We acquired six entities during the six months ended December 31, 2008 for total consideration of $879 million which was paid primarily in cash. All of the entities have been consolidated into our results of operations since their respective acquisition dates. The purchase price allocations for these acquisitions are preliminary for up to 12 months after the acquisition date and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available. Any change in the estimated fair value of the net assets of the acquired companies will change the amount of the purchase price allocable to goodwill. Pro forma results of operations have not been presented because the effects of these acquisitions, individually and in aggregate, were not material to our consolidated results of operations.

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Note 7 Goodwill

		Three Months Ended December 31, 2008		
(In millions)	Balance as of October 1, 2008	Acquisitions	Purchase accounting adjustments and other	Balance as of December 31, 2008
Client	$ 153	$	$	$ 153
Server and Tools	971			971
Online Services Business	6,308	392	(1)	6,699
Microsoft Business Division	4,083		(189)	3,894
Entertainment and Devices Division	776		(3)	773
Total	$ 12,291	$ 392	$ (193)	$ 12,490

		Six Months Ended December 31, 2008		
(In millions)	Balance as of July 1, 2008	Acquisitions	Purchase accounting adjustments and other	Balance as of December 31, 2008
Client	$ 153	$	$	$ 153
Server and Tools	738	233		971
Online Services Business	6,274	447	(22)	6,699
Microsoft Business Division	4,191		(297)	3,894
Entertainment and Devices Division	752	24	(3)	773
Total	$ 12,108	$ 704	$ (322)	$ 12,490

None of the amounts recorded as goodwill are expected to be deductible for tax purposes. The purchase price allocations for all of the acquisitions are preliminary for up to 12 months after the acquisition date and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available. Any change in the fair value of the net assets of the acquired companies will change the amount of the purchase price allocable to goodwill. Changes in the goodwill amounts resulting from foreign currency translations are included in purchase accounting adjustments and other in the above table.

Given the continuing deterioration of economic conditions, we performed an interim impairment analysis of certain goodwill balances as of December 31, 2008 (goodwill is tested for impairment on an annual basis and between annual tests if indicators of potential impairment exist, using a fair-value-based approach). No impairment of goodwill was identified during the interim testing, nor has an impairment of goodwill been identified during any of the periods presented.

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Note 8 Intangible Assets

The components of finite-lived intangible assets were as follows:

	December 31, 2008			June 30, 2008		
(In millions)	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
Contract-based	**$ 1,072**	**$ (824)**	**$ 248**	$ 1,074	$ (796)	$ 278
Technology-based	**1,764**	**(848)**	**916**	1,677	(672)	1,005
Marketing-related	**185**	**(80)**	**105**	171	(65)	106
Customer-related	**726**	**(180)**	**546**	708	(124)	584
Total	**$ 3,747**	**$ (1,932)**	**$ 1,815**	$ 3,630	$ (1,657)	$ 1,973

Acquired intangibles are generally amortized on a straight-line basis over their weighted average lives. Intangible assets amortization expense was $145 million for the three months and $285 million for the six months ended December 31, 2008 as compared with $112 million for the three months and $214 million for the six months ended December 31, 2007. The following table outlines the estimated future amortization expense related to intangible assets as of December 31, 2008:

(In millions)	Amount
Year Ended June 30,	
2009	**$ 299**
2010	**518**
2011	**433**
2012	**294**
2013 and thereafter	**271**
Total	**$ 1,815**

Note 9 Debt

In September 2008, our Board of Directors authorized debt financings of up to $6.0 billion. Pursuant to the authorization, we established a commercial paper program providing for the issuance and sale of up to $2.0 billion in short-term commercial paper. As of December 31, 2008, $2.0 billion of the commercial paper was issued and outstanding with a weighted average interest rate, including issuance costs, of 0.3% and maturities of 29 to 93 days.

In September 2008, we also entered into a $2.0 billion six-month senior unsecured credit facility, principally to support the commercial paper program. In November 2008, we replaced the six-month credit facility with a new $2.0 billion 364-day credit facility. The new credit facility expires on November 6, 2009. As of December 31, 2008, we were in compliance with the only financial covenant in the credit agreement, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facility during the three months ended December 31, 2008.

In November 2008, we filed a shelf registration statement with the U.S. Securities and Exchange Commission that allows us to issue debt securities from time to time pursuant to the September 2008 authorization for debt financings of up to $6.0 billion. As of December 31, 2008, no debt securities had been issued under this registration statement.

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Note 10 Income Taxes

Our effective tax rates were 26% for the three months and 27% for the six months ended December 31, 2008, and 31% for the three and six months ended December 31, 2007. The fiscal year 2009 rates reflect a decline in the recurring effective tax rates primarily as a result of foreign earnings taxed at lower rates.

During the first quarter of fiscal year 2009, we paid the Internal Revenue Service (IRS) approximately $3.1 billion as a result of our settlement with the IRS on its 2000-2003 examination.

Tax contingencies and other tax liabilities were $5.1 billion as of December 31, 2008 and $3.8 billion as of June 30, 2008, and were included in other long-term liabilities.

Note 11 Unearned Revenue

The components of unearned revenue were as follows:

(In millions)	December 31, 2008	June 30, 2008
Volume licensing programs	$ 10,451	$ 12,232
Undelivered elements	1,086	1,396
Other	1,529	1,669
Total	$ 13,066	$ 15,297

Unearned revenue by segment was as follows:

(In millions)	December 31, 2008	June 30, 2008
Client	$ 2,178	$ 2,738
Server and Tools	4,303	5,007
Microsoft Business Division	6,077	7,101
Other	508	451
Total	$ 13,066	$ 15,297

Note 12 Contingencies

Government competition law matters. In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were not reasonable. Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should accrue after that date. On February 27, 2008, the Commission issued a fine of $1.4 billion (899 million) relating to the period prior to October 22, 2007. In May 2008, we filed an application with the European Court of First Instance to annul the February 2008 fine.

We paid the $1.4 billion (899 million) fine in June 2008.

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In January 2008 the Commission opened a competition law investigation related to the inclusion of various capabilities in our Windows operating system software, including Web browsing software. The investigation was precipitated by a complaint filed with the Commission by Opera Software ASA, a firm that offers Web browsing software. On January 15, 2009, the European Commission issued a statement of objections expressing the Commission s preliminary view that the inclusion of Internet Explorer in Windows since 1996 has violated European competition law. According to the statement of objections, other browsers are foreclosed from competing because Windows includes Internet Explorer. We will have an opportunity to respond in writing to the statement of objections within about two months. We may also request a hearing, which would take place after the submission of this response. Under European Union procedure, the European Commission will not make a final determination until after it receives and assesses our response and conducts the hearing, should we request one. The statement of objections seeks to impose a remedy that is different than the remedy imposed in the earlier proceeding concerning Windows Media Player. While computer users and OEMs are already free to run any Web browsing software on Windows, the Commission is considering ordering Microsoft and OEMs to obligate users to choose a particular browser when setting up a new PC. Such a remedy might include a requirement that OEMs distribute multiple browsers on new Windows-based PCs. We may also be required to disable certain unspecified Internet Explorer software code if a user chooses a competing browser. The statement of objections also seeks to impose a significant fine based on sales of Windows operating systems in the European Union. In January 2008, the Commission opened an additional competition law investigation that relates primarily to interoperability with respect to our Microsoft Office family of products. This investigation resulted from complaints filed with the Commission by a trade association of Microsoft s competitors.

We are subject to a Consent Decree and Final Judgment that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Consent Decree imposed various constraints on our Windows operating system businesses. Portions of the Consent Decree were scheduled to expire on January 31, 2008; we voluntarily agreed to extend other elements of the Consent Decree to November 2009. In October 2007, some states filed a motion with the U.S. District Court for the District of Columbia seeking to have most of the remaining provisions of the Final Judgment in the action to which they are party extended for five years. The U.S. Department of Justice and other states advised the Court that they would not seek any extension of the Final Judgments to which they are party. In January 2008, the court issued a decision granting the states motion to extend these additional provisions of the consent decree until November 2009.

In other ongoing investigations, various foreign governments and several state attorneys general have requested information from us concerning competition, privacy, and security issues.

Antitrust, unfair competition, and overcharge class actions. A large number of antitrust and unfair competition class action lawsuits have been filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals of damages claims of indirect purchasers under federal law and in 15 states. Courts refused to certify classes in two additional states. We have reached agreements to settle all claims that have been made to date in 19 states and the District of Columbia.

Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a

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percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers.

The settlements in all states have received final court approval. Cases in Arizona, Mississippi, and Canada have not been settled. We estimate the total cost to resolve all of the overcharge class action cases will range between $1.7 billion and $1.9 billion. The actual cost depends on factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims. At December 31, 2008, we have recorded a liability related to these claims of approximately $900 million, which reflects our estimated exposure of $1.7 billion less payments made to date of approximately $800 million, mostly for administrative expenses, vouchers, and legal fees.

Other antitrust litigation and claims. In November 2004, Novell, Inc. filed a complaint in U.S. District Court, asserting antitrust and unfair competition claims against us related to Novell s ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. This case was transferred to Maryland. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. Both parties appealed, and in October 2007, the court of appeals affirmed the decision of the trial court, and remanded the case to that court for further proceedings. Discovery is continuing.

Patent and intellectual property claims. Microsoft and Alcatel-Lucent have been parties to a number of legal proceedings beginning in 2003 relating to certain patents of each of the companies. Because some of these actions began before the merger of Alcatel and Lucent in 2006, for simplicity we refer to the post-merger entity of Alcatel-Lucent throughout this discussion.

In 2003 we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents. Alcatel-Lucent has asserted claims under these patents against computer manufacturers that sell computers with our operating system and application software pre-installed. In February 2007, the jury returned a verdict in Alcatel-Lucent s favor in the first of a series of patent trials, and awarded $1.5 billion in damages. In August 2007, on our motions for judgment as a matter of law, the trial court overturned the jury verdict and dismissed plaintiff s claims on multiple grounds. Alcatel-Lucent appealed, and in September 2008, the court of appeals affirmed the trial court s dismissal of the claim.

In April 2008, a jury returned a verdict in Alcatel-Lucent s favor in a trial on a consolidated group of one video and three user interface patents. The jury concluded that Microsoft had infringed two user interface patents and awarded $367 million in damages. In June 2008, the trial judge increased the amount of damages to $512 million, to include $145 million of interest. Microsoft has appealed.

In March 2006, Alcatel-Lucent filed a lawsuit against us in U.S. District Court in California, claiming Windows Vista, Windows Media Player, and the Xbox 360 infringe one of its patents. The Alcatel-Lucent patent, together with five other patents, was then assigned to a separate

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entity, the Multimedia Patent Trust (MPT). Alcatel-Lucent created the MPT immediately prior to the companies merger and transferred these patents to the trust. In response, we asserted counterclaims that Alcatel-Lucent infringes 10 Microsoft patents by its sale of various products.

In November 2006, Alcatel-Lucent filed two patent infringement cases against us in U.S. District Court in Texas, asserting Mediaroom and various networking functionalities violate seven of its patents. In April 2007, we asserted infringement counterclaims based on four of our patents relating to functionality similar to that accused by Alcatel-Lucent.

In February 2007, we filed a complaint against Alcatel-Lucent with the International Trade Commission claiming Alcatel-Lucent is infringing four Microsoft patents related to our unified communications technology and seeking to prevent the import into the U.S. of certain Alcatel-Lucent unified communications products.

In December 2008, we entered into a settlement agreement resolving all of the matters described above, except one of the two patents the jury concluded we had infringed in the April 2008 verdict. This settlement did not have a significant impact on our financial statements. Approximately $500 million remains in dispute in the remaining matter.

Other. We are also 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 financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties and management s view of these matters may change in the future.

As of December 31, 2008, we had accrued aggregate liabilities of approximately $500 million in other current liabilities and approximately $500 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could be up to $900 million in aggregate beyond recorded amounts. The forgoing amount does not include the January 15, 2009 European Commission statement of objections, the outcome and range of which is not reasonably estimable. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial position, results of operations, and cash flows for the period in which the effects become reasonably estimable.

Note 13 Product Warranties

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

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The changes in our aggregate product warranty liabilities were as follows:

(In millions)	Three Months Ended December 31, 2008	Six Months Ended December 31, 2008
Balance, beginning of period	$ 570	$ 692
Accrual for warranties issued	75	107
Adjustments to pre-existing warranties	(11)	(25)
Settlements of warranty claims	(144)	(284)
Balance, end of period	$ 490	$ 490

Note 14 Stockholders Equity

Share Repurchases

On September 22, 2008, we announced the completion of the two repurchase programs approved by our Board of Directors during the first quarter of fiscal year 2007 to buy back up to $40.0 billion of Microsoft common stock.

On September 22, 2008, we also announced that our Board of Directors approved a new share repurchase program authorizing up to $40.0 billion in share repurchases with an expiration date of September 30, 2013. As of December 31, 2008, approximately $34.5 billion remained of the $40.0 billion approved repurchase amount. All repurchases were made using cash resources. The repurchase program may be suspended or discontinued at any time without notice.

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

(In millions)	Three Months Ended December 31, 2008	2007	Six Months Ended December 31, 2008	2007
Shares of common stock repurchased	**94**	120	**318**	200
Value of common stock repurchased	**$ 2,234**	$ 4,081	**$ 8,200**	$ 6,429

Of the 318 million shares repurchased during the six months ended December 31, 2008, 101 million shares were repurchased for $2.7 billion under the repurchase program approved by our Board of Directors during the first quarter of fiscal year 2007 and 217 million shares were repurchased for $5.5 billion under the repurchase program approved by our Board of Directors in September 2008.

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Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Per Share Dividend	Record Date	Total Amount (in millions)	Payment Date
(Fiscal year 2009)				
September 22, 2008	$			