

MICROSOFT CORP  
Form 10-Q  
October 28, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2010

**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

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**MICROSOFT CORPORATION**

(Exact name of registrant as specified in its charter)

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Washington  
(State or other jurisdiction of  
incorporation or organization)

91-1144442  
(I.R.S. Employer  
Identification No.)

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One Microsoft Way, Redmond, Washington  
(Address of principal executive offices)

98052-6399  
(Zip Code)

(425) 882-8080

(Registrant's telephone number, including area code)

None

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

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

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

Class	Outstanding at October 22, 2010
Common Stock, \$0.00000625 par value per share	8,555,523,242 shares

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**FORM 10-Q**

**For the Quarter Ended September 30, 2010**

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## Item 1

**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****INCOME STATEMENTS**

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

<b>Three Months Ended September 30,</b>	<b>2010</b>	<b>2009</b>
Revenue	<b>\$ 16,195</b>	\$ 12,920
Operating expenses:		
Cost of revenue	<b>3,139</b>	2,842
Research and development	<b>2,196</b>	2,065
Sales and marketing	<b>2,806</b>	2,790
General and administrative	<b>938</b>	741
Total operating expenses	<b>9,079</b>	8,438
Operating income	<b>7,116</b>	4,482
Other income	<b>114</b>	283
Income before income taxes	<b>7,230</b>	4,765
Provision for income taxes	<b>1,820</b>	1,191
Net income	<b>\$ 5,410</b>	\$ 3,574
Earnings per share:		
Basic	<b>\$ 0.63</b>	\$ 0.40
Diluted	<b>\$ 0.62</b>	\$ 0.40
Weighted average shares outstanding:		
Basic	<b>8,614</b>	8,914
Diluted	<b>8,695</b>	8,983
Cash dividends declared per common share	<b>\$ 0.16</b>	\$ 0.13

See accompanying notes.

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**BALANCE SHEETS**

(In millions)

	September 30, 2010 (Unaudited)	June 30, 2010 <sup>(1)</sup>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,161	\$ 5,505
Short-term investments (including securities loaned of \$683 and \$62)	36,012	31,283
Total cash, cash equivalents, and short-term investments	44,173	36,788
Accounts receivable, net of allowance for doubtful accounts of \$312 and \$375	9,646	13,014
Inventories	1,242	740
Deferred income taxes	2,344	2,184
Other	2,176	2,950
Total current assets	59,581	55,676
Property and equipment, net of accumulated depreciation of \$8,942 and \$8,629	7,771	7,630
Equity and other investments	9,211	7,754
Goodwill	12,471	12,394
Intangible assets, net	1,077	1,158
Other long-term assets	1,429	1,501
Total assets	\$ 91,540	\$ 86,113
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Accounts payable	\$ 3,654	\$ 4,025
Short-term debt	1,000	1,000
Accrued compensation	2,252	3,283
Income taxes	2,136	1,074
Short-term unearned revenue	12,767	13,652
Securities lending payable	909	182
Other	3,139	2,931
Total current liabilities	25,857	26,147
Long-term debt	9,665	4,939
Long-term unearned revenue	1,152	1,178
Deferred income taxes	540	229
Other long-term liabilities	7,384	7,445

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Total liabilities	<b>44,598</b>	39,938
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding <b>8,562</b> and 8,668	<b>61,935</b>	62,856
Retained deficit, including accumulated other comprehensive income of <b>\$1,519</b> and \$1,055	<b>(14,993)</b>	(16,681)
Total stockholders' equity	<b>46,942</b>	46,175
Total liabilities and stockholders' equity	<b>\$ 91,540</b>	\$ 86,113

(1) *Derived from audited financial statements.*  
See accompanying notes.

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**CASH FLOWS STATEMENTS**

(In millions) (Unaudited)

Three Months Ended September 30,	2010	2009
<b>Operations</b>		
Net income	\$ 5,410	\$ 3,574
Adjustments to reconcile net income to net cash from operations:		
Depreciation, amortization, and other noncash items	694	646
Stock-based compensation expense	528	443
Net recognized gains on investments and derivatives	(29)	(66)
Excess tax benefits from stock-based compensation	(5)	(9)
Deferred income taxes	(148)	(46)
Deferral of unearned revenue	5,881	6,679
Recognition of unearned revenue	(6,862)	(6,237)
Changes in operating assets and liabilities:		
Accounts receivable	3,674	2,748
Inventories	(468)	(419)
Other current assets	208	(235)
Other long-term assets	62	(78)
Accounts payable	(400)	(36)
Other current liabilities	(911)	(1,203)
Other long-term liabilities	560	346
Net cash from operations	8,194	6,107
<b>Financing</b>		
Short-term borrowings, maturities of 90 days or less, net	814	378
Proceeds from issuance of debt, maturities longer than 90 days	4,721	695
Repayments of debt, maturities longer than 90 days	(814)	(823)
Common stock issued	177	248
Common stock repurchased	(4,399)	(1,540)
Common stock cash dividends paid	(1,118)	(1,157)
Excess tax benefits from stock-based compensation	5	9
Other	(25)	0
Net cash used in financing	(639)	(2,190)
<b>Investing</b>		
Additions to property and equipment	(564)	(435)
Acquisition of companies, net of cash acquired	0	(39)
Purchases of investments	(7,417)	(10,490)
Maturities of investments	870	3,498
Sales of investments	1,427	4,417
Securities lending payable	727	1,850

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Net cash used in investing	(4,957)	(1,199)
Effect of exchange rates on cash and cash equivalents	58	29
Net change in cash and cash equivalents	2,656	2,747
Cash and cash equivalents, beginning of period	5,505	6,076
Cash and cash equivalents, end of period	<u>\$ 8,161</u>	<u>\$ 8,823</u>

See accompanying notes.



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**STOCKHOLDERS' EQUITY STATEMENTS**

(In millions) (Unaudited)

Three Months Ended September 30,	2010	2009
<b>Common stock and paid-in capital</b>		
Balance, beginning of period	\$ 62,856	\$ 62,382
Common stock issued	177	248
Common stock repurchased	(1,575)	(733)
Stock-based compensation	528	443
Stock-based compensation income tax deficiencies	(52)	(46)
Other, net	1	(1)
Balance, end of period	61,935	62,293
<b>Retained deficit</b>		
Balance, beginning of period	(16,681)	(22,824)
Net income	5,410	3,574
Other comprehensive income:		
Net unrealized losses on derivatives	(506)	(319)
Net unrealized gains on investments	732	588
Translation adjustments and other	238	96
Comprehensive income	5,874	3,939
Common stock cash dividends	(1,362)	(1,157)
Common stock repurchased	(2,824)	(1,039)
Balance, end of period	(14,993)	(21,081)
Total stockholders' equity	\$ 46,942	\$ 41,212

See accompanying notes.

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Item 1

**NOTES TO FINANCIAL STATEMENTS**

*(Unaudited)*

**NOTE 1 ACCOUNTING POLICIES**

**Basis of Presentation and Use of Estimates**

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

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2010 Form 10-K filed on July 30, 2010 with the U.S. Securities and Exchange Commission.

**Principles of Consolidation**

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

**Recently Adopted Accounting Guidance**

On July 1, 2010, we adopted guidance issued by the Financial Accounting Standards Board ( FASB ) on revenue recognition. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product are no longer within the scope of the software revenue recognition guidance, and software-enabled products are now subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2010, we also adopted guidance issued by the FASB on the consolidation of variable interest entities. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. Adoption of the new guidance did not have a material impact on our financial statements.

**Recent Accounting Guidance Not Yet Adopted**

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In January 2010, the FASB issued guidance to amend the disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on our financial statements.

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**NOTE 2 EARNINGS PER SHARE**

Basic earnings per share is computed based on the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share 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, stock awards, and shared performance stock awards. The components of basic and diluted earnings per share are as follows:

(In millions, except earnings per share)

Three Months Ended September 30,	2010	2009
Net income available for common shareholders (A)	\$ 5,410	\$ 3,574
Weighted average shares of common stock (B)	8,614	8,914
Dilutive effect of stock-based awards	81	69
Common stock and common stock equivalents (C)	8,695	8,983
<b>Earnings Per Share</b>		
Basic (A/B)	\$ 0.63	\$ 0.40
Diluted (A/C)	\$ 0.62	\$ 0.40

We excluded 104 million shares and 224 million shares underlying stock-based awards from the calculations of diluted earnings per share for the three months ended September 30, 2010 and 2009, respectively, because their inclusion would have been anti-dilutive.

In June 2010, we issued \$1.25 billion of zero-coupon debt securities that are convertible into shares of our common stock if certain conditions are met. Shares of common stock into which the debt could convert were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. See also Note 10 Debt.

**NOTE 3 OTHER INCOME**

The components of other income were as follows:

(In millions)

Three Months Ended September 30,	2010	2009
Dividends and interest income	\$ 210	\$ 203
Interest expense	(45)	(38)
Net recognized gains on investments	34	70
Net losses on derivatives	(5)	(4)
Net gains (losses) on foreign currency remeasurements	(42)	55
Other	(38)	(3)

Total	<u>\$ 114</u>	<u>\$ 283</u>
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**NOTE 4 INVESTMENTS****Investment Components**

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

					Cash		Equity
		Unrealized	Unrealized	Recorded	and Cash	Short-term	and Other
(In millions)	Cost Basis	Gains	Losses	Basis	Equivalents	Investments	Investments
<b>September 30, 2010</b>							
Cash	\$ 1,911	\$ 0	\$ 0	\$ 1,911	\$ 1,911	\$ 0	\$ 0
Mutual funds	1,487	0	0	1,487	1,487	0	0
Commercial paper	54	0	0	54	5	49	0
Certificates of deposit	636	0	0	636	410	226	0
U.S. Government and Agency securities	27,470	198	(1)	27,667	3,398	24,269	0
Foreign government bonds	532	15	0	547	0	547	0
Mortgage-backed securities	2,838	132	0	2,970	0	2,970	0
Corporate notes and bonds	7,897	403	(22)	8,278	950	7,328	0
Municipal securities	559	29	0	588	0	588	0
Common and preferred stock	7,112	1,772	(188)	8,696	0	0	8,696
Other investments	550	0	0	550	0	35	515
<b>Total</b>	<b>\$ 51,046</b>	<b>\$ 2,549</b>	<b>\$ (211)</b>	<b>\$ 53,384</b>	<b>\$ 8,161</b>	<b>\$ 36,012</b>	<b>\$ 9,211</b>

					Cash		Equity
		Unrealized	Unrealized	Recorded	and Cash	Short-term	and Other
(In millions)	Cost Basis	Gains	Losses	Basis	Equivalents	Investments	Investments
<b>June 30, 2010</b>							
Cash	\$ 1,661	\$ 0	\$ 0	\$ 1,661	\$ 1,661	\$ 0	\$ 0
Mutual funds	1,120	0	0	1,120	1,120	0	0
Commercial paper	188	0	0	188	13	175	0
Certificates of deposit	348	0	0	348	68	280	0
U.S. Government and Agency securities	21,036	167	(1)	21,202	1,822	19,380	0
Foreign government bonds	518	13	0	531	0	531	0
Mortgage-backed securities	3,137	135	(7)	3,265	0	3,265	0
Corporate notes and bonds	7,450	289	(18)	7,721	701	7,020	0
Municipal securities	726	22	(1)	747	120	627	0

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Common and preferred stock	6,640	1,030	(418)	7,252	0	0	7,252
Other investments	507	0	0	507	0	5	502
<hr/>							
Total	\$ 43,331	\$ 1,656	\$ (445)	\$ 44,542	\$ 5,505	\$ 31,283	\$ 7,754
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**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	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
<b>September 30, 2010</b>						
U.S. Government and Agency securities	\$ 4,975	\$ (1)	\$ 0	\$ 0	\$ 4,975	\$ (1)
Corporate notes and bonds	139	(20)	78	(2)	217	(22)
Common and preferred stock	1,330	(145)	213	(43)	1,543	(188)
<b>Total</b>	<b>\$ 6,444</b>	<b>\$ (166)</b>	<b>\$ 291</b>	<b>\$ (45)</b>	<b>\$ 6,735</b>	<b>\$ (211)</b>

(In millions)	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
<b>June 30, 2010</b>						
U.S. Government and Agency securities	\$ 216	\$ (1)	\$ 0	\$ 0	\$ 216	\$ (1)
Mortgage-backed securities	105	(6)	18	(1)	123	(7)
Corporate notes and bonds	1,124	(13)	89	(5)	1,213	(18)
Municipal securities	66	(1)	0	0	66	(1)
Common and preferred stock	2,102	(339)	190	(79)	2,292	(418)
<b>Total</b>	<b>\$ 3,613</b>	<b>\$ (360)</b>	<b>\$ 297</b>	<b>\$ (85)</b>	<b>\$ 3,910</b>	<b>\$ (445)</b>

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 as of September 30, 2010.

At September 30, 2010 and June 30, 2010, the recorded bases and estimated fair values of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were \$242 million and \$216 million, respectively.

**Debt Investment Maturities**



(In millions)	Estimated	
	Cost Basis	Fair Value
<b>September 30, 2010</b>		
Due in one year or less	\$ 20,397	\$ 20,448
Due after one year through five years	13,779	14,121
Due after five years through 10 years	2,364	2,547
Due after 10 years	3,446	3,624
Total	\$ 39,986	\$ 40,740

**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. currency equivalents.

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**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, and Canadian dollar. As of September 30, 2010 and June 30, 2010, the total notional amounts of these foreign exchange contracts sold were \$13.7 billion and \$9.3 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 September 30, 2010 and June 30, 2010, the total notional amounts of these foreign exchange contracts sold were \$534 million and \$523 million, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of September 30, 2010, the total notional amounts of these foreign exchange contracts purchased and sold were \$4.3 billion and \$4.0 billion, respectively. As of June 30, 2010, the total notional amounts of these foreign exchange contracts purchased and sold were \$7.8 billion and \$5.3 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 September 30, 2010, the total notional amounts of designated and non-designated equity contracts purchased and sold were \$1.4 billion and \$659 million, respectively. As of June 30, 2010, the total notional amounts of designated and non-designated equity contracts purchased and sold were \$918 million and \$472 million, respectively.

**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 September 30, 2010, the total notional amounts of fixed-interest rate contracts purchased and sold were \$1.8 billion and \$2.0 billion, respectively. As of June 30, 2010, the total notional amounts of fixed-interest rate contracts purchased and sold were \$3.1 billion and \$1.8 billion, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of September 30, 2010 and June 30, 2010, the total notional derivative amount of mortgage contracts purchased were \$516 million and \$305 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 September 30, 2010 and June 30, 2010, the total notional amounts of credit contracts purchased and sold were immaterial.

**Commodity**

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swap, futures and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the

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purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of September 30, 2010, the total notional amounts of commodity contracts purchased and sold were \$1.2 billion and \$458 million, respectively. As of June 30, 2010, the total notional amounts of commodity contracts purchased and sold were \$1.1 billion and \$376 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 a 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 September 30, 2010, our long-term unsecured debt rating was AAA, and cash investments were in excess of \$1.0 billion. As a result, no collateral is 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 a derivative instrument designated as a fair-value hedge, the gain (loss) is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item 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 derivative's gain (loss) is initially reported as a component of other comprehensive income (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). Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are moved from OCI into other income (expense).

Following are the gross fair values of derivative instruments held at September 30, 2010 and June 30, 2010, excluding 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)	Foreign		Interest			Total
	Exchange	Equity	Rate	Credit	Commodity	
	Contracts	Contracts	Contracts	Contracts	Contracts	Derivatives
<b>September 30, 2010</b>						
<b>Assets</b>						
Derivatives not designated as hedging instruments:						
Short-term investments	\$ 6	\$ 170	\$ 14	\$ 6	\$ 55	\$ 251

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Other current assets	107	0	0	0	0	107
Total	\$ 113	\$ 170	\$ 14	\$ 6	\$ 55	\$ 358
Derivatives designated as hedging instruments:						
Short-term investments	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Other current assets	142	0	0	0	0	142
Total	\$ 142	\$ 0	\$ 0	\$ 0	\$ 0	\$ 142
Total assets	\$ 255	\$ 170	\$ 14	\$ 6	\$ 55	\$ 500
<b>Liabilities</b>						
Derivatives not designated as hedging instruments:						
Other current liabilities	\$ (83)	\$ (12)	\$ (14)	\$ (20)	\$ (16)	\$ (145)
Derivatives designated as hedging instruments:						
Other current liabilities	\$ (374)	\$ 0	\$ 0	\$ 0	\$ 0	\$ (374)
Total liabilities	\$ (457)	\$ (12)	\$ (14)	\$ (20)	\$ (16)	\$ (519)

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	<b>Foreign</b>		<b>Interest</b>			
	<b>Exchange</b>	<b>Equity</b>	<b>Rate</b>	<b>Credit</b>	<b>Commodity</b>	<b>Total</b>
<b>(In millions)</b>	<b>Contracts</b>	<b>Contracts</b>	<b>Contracts</b>	<b>Contracts</b>	<b>Contracts</b>	<b>Derivatives</b>
<b>June 30, 2010</b>						
<b>Assets</b>						
Derivatives not designated as hedging instruments:						
Short-term investments	\$ 15	\$ 134	\$ 12	\$ 7	\$ 8	\$ 176
Other current assets	34	0	0	0	0	34
<b>Total</b>	<b>\$ 49</b>	<b>\$ 134</b>	<b>\$ 12</b>	<b>\$ 7</b>	<b>\$ 8</b>	<b>\$ 210</b>
Derivatives designated as hedging instruments:						
Short-term investments	\$ 3	\$ 0	\$ 0	\$ 0	\$ 0	\$ 3
Other current assets	563	0	0	0	0	563
<b>Total</b>	<b>\$ 566</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 566</b>
<b>Total assets</b>	<b>\$ 615</b>	<b>\$ 134</b>	<b>\$ 12</b>	<b>\$ 7</b>	<b>\$ 8</b>	<b>\$ 776</b>
<b>Liabilities</b>						
Derivatives not designated as hedging instruments:						
Other current liabilities	\$ (60)	\$ (17)	\$ (33)	\$ (41)	\$ (5)	\$ (156)
Derivatives designated as hedging instruments:						
Other current liabilities	\$ (9)	\$ 0	\$ 0	\$ 0	\$ 0	\$ (9)
<b>Total liabilities</b>	<b>\$ (69)</b>	<b>\$ (17)</b>	<b>\$ (33)</b>	<b>\$ (41)</b>	<b>\$ (5)</b>	<b>\$ (165)</b>

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

**Fair-Value Hedges**

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

**(In millions)**

<b>Three Months Ended September 30,</b>	<b>2010</b>	<b>2009</b>
<b>Foreign Exchange Contracts</b>		
Derivatives	\$ (52)	\$ (193)
Hedged items	50	188

Total	\$ (2)	\$ (5)
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**Cash-Flow Hedges**

We recognized the following gains (losses) related to foreign exchange contracts designated as cash flow hedges (our only cash flow hedges during the period):

(In millions)

Three Months Ended September 30,	2010	2009
<b>Effective Portion</b>		
Losses recognized in OCI, net of tax effect of \$(243) and \$(112)	\$ (452)	\$ (209)
Gain reclassified from OCI into revenue	\$ 84	\$ 169
<b>Amount Excluded from Effectiveness Assessment and Ineffective Portion</b>		
Loss recognized in other income	\$ (87)	\$ (40)

We estimate that \$3 million of net derivative losses included in OCI will be reclassified into earnings within the next 12 months. No significant amounts of gains (losses) were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the three months ended September 30, 2010.

**Non-Designated Derivatives**

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). 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), which were immaterial for the three months ended September 30, 2010 and 2009. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities.

(In millions)

Three Months Ended September 30,	2010	2009
Foreign exchange contracts	\$ (60)	\$ 43
Equity contracts	33	9
Interest-rate contracts	(12)	3
Credit contracts	18	9
Commodity contracts	65	15
<b>Total</b>	<b>\$ 44</b>	<b>\$ 79</b>



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**NOTE 6 FAIR VALUE MEASUREMENTS**

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

*Level 1* inputs are based upon unadjusted quoted prices for identical instruments traded in active markets. Our Level 1 non-derivative investments primarily include U.S. treasuries, 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, foreign exchange rates, and forward and spot prices for currencies and commodities. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, mortgage-backed securities, agency securities, certificates of deposit, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.

*Level 3* inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models. Our Level 3 non-derivative assets primarily comprise investments in certain corporate bonds. We value these corporate bonds using internally developed valuation models, inputs to which include interest rate curves, credit spreads, stock prices, and volatilities. Unobservable inputs used in these models are significant to the fair values of the investments. Our Level 3 derivative assets and liabilities primarily comprise derivatives for foreign equities. In certain cases, market-based observable inputs are not available and we use management judgment to develop assumptions to determine fair value for these derivatives.

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

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

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

(In millions)	Gross Fair					Net Fair Value
	Level 1	Level 2	Level 3	Value	Netting <sup>(a)</sup>	
September 30, 2010						
Assets						
Mutual funds	\$ 1,487	\$ 0	\$ 0	\$ 1,487	\$ 0	\$ 1,487
Commercial paper	0	53	0	53	0	53
Certificates of deposit	0	636	0	636	0	636
U.S. Government and Agency securities	20,249	7,429	0	27,678	0	27,678
Foreign government bonds	263	318	0	581	0	581
Mortgage-backed securities	0	2,970	0	2,970	0	2,970
Corporate notes and bonds	0	7,939	167	8,106	0	8,106
Municipal securities	0	588	0	588	0	588
Common and preferred stock	8,396	54	5	8,455	0	8,455
Derivatives	24	460	16	500	(366)	134
Total	\$ 30,419	\$ 20,447	\$ 188	\$ 51,054	\$ (366)	\$ 50,688
Liabilities						
Derivatives and other	\$ 80	\$ 499	\$ 0	\$ 579	\$ (366)	\$ 213

	Gross Fair					Net Fair Value
(In millions)	Level 1	Level 2	Level 3	Value	Netting <sup>(a)</sup>	
June 30, 2010						
Assets						
Mutual funds	\$ 1,120	\$ 0	\$ 0	\$ 1,120	\$ 0	\$ 1,120
Commercial paper	0	172	0	172	0	172
Certificates of deposit	0	348	0	348	0	348
U.S. Government and Agency securities	16,473	4,756	0	21,229	0	21,229
Foreign government bonds	239	294	0	533	0	533
Mortgage-backed securities	0	3,264	0	3,264	0	3,264
Corporate notes and bonds	0	7,460	167	7,627	0	7,627
Municipal securities	0	747	0	747	0	747

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Common and preferred stock	6,988	43	5	7,036	0	7,036
Derivatives	22	745	9	776	(207)	569
<hr/>						
Total	\$ 24,842	\$ 17,829	\$ 181	\$ 42,852	\$ (207)	\$ 42,645
<hr/>						
<b>Liabilities</b>						
Derivatives and other	\$ 85	\$ 137	\$ 0	\$ 222	\$ (205)	\$ 17
<hr/>						

- (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.*

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The table below reconciles the total Net Fair Value of assets above to the balance sheet presentation of these same assets in Note 4 Investments for September 30, 2010 and June 30, 2010.

(In millions)

	September 30, 2010	June 30, 2010
Net fair value of assets measured at fair value on a recurring basis	\$ 50,688	\$ 42,645
Cash	1,911	1,661
Common and preferred stock measured at fair value on a nonrecurring basis	242	216
Other investments measured at fair value on a nonrecurring basis	515	502
Less derivative assets classified as other current assets	(32)	(544)
Other	60	62
Recorded basis of investment components	\$ 53,384	\$ 44,542

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

The following tables present the changes during the three months ended September 30, 2010 and 2009 in our Level 3 financial instruments that are measured at fair value on a recurring basis. The majority of these instruments consist of investment securities classified as available-for-sale with changes in fair value included in OCI.

	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
(In millions)				
<b>Three Months Ended September 30, 2010</b>				
Balance, beginning of period	\$ 167	\$ 5	\$ 9	\$ 181
Total realized and unrealized gains (losses):				
Included in other income	2	0	7	9
Included in other comprehensive income	(2)	0	0	(2)
Balance, end of period	\$ 167	\$ 5	\$ 16	\$ 188
	\$ 2	\$ 0	\$ 7	\$ 9

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Change in unrealized gains (losses) included in other income related to assets held as of  
September 30, 2010

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
<b>Three Months Ended September 30, 2009</b>				
Balance, beginning of period	\$ 253	\$ 5	\$ 5	\$ 263
Total realized and unrealized gains (losses):				
Included in other income	1	0	(2)	(1)
Included in other comprehensive income	(74)	0	0	(74)
Balance, end of period	\$ 180	\$ 5	\$ 3	\$ 188
Change in unrealized gains (losses) included in other income related to assets held as of September 30, 2009	\$ 1	\$ 0	\$ (2)	\$ (1)

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

During the three months ended September 30, 2010 and 2009, we did not record any other-than-temporary impairments on those assets required to be measured at fair value on a non-recurring basis.

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**NOTE 7 INVENTORIES**

The components of inventories were as follows:

(In millions)

	September 30, 2010	June 30, 2010
Raw materials	\$ 189	\$ 172
Work in process	10	16
Finished goods	1,043	552
Total	<u>\$ 1,242</u>	<u>\$ 740</u>

**NOTE 8 GOODWILL**

Changes in our goodwill balances during the three months ended September 30, 2010 were as follows:

	Balance	Acquisitions	Purchase Accounting Adjustments and Other	Balance
(In millions)	June 30, 2010			September 30, 2010
Windows & Windows Live Division	\$ 77	\$ 0	\$ 12	\$ 89
Server and Tools	1,118	0	7	1,125
Online Services Division	6,373	0	0	6,373
Microsoft Business Division	4,024	0	78	4,102
Entertainment and Devices Division	802	0	(20)	782
Total	<u>\$ 12,394</u>	<u>\$ 0</u>	<u>\$ 77</u>	<u>\$ 12,471</u>

We do not expect any of the amounts recorded as goodwill to be deductible for tax purposes. The measurement period for purchase price allocations ends as soon as information on the facts and circumstances becomes available, but will not exceed 12 months. Adjustments in the purchase price allocation may require a recasting of the amounts allocated to goodwill retroactive to the period in which the acquisition

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occurred. Any change in the goodwill amounts resulting from foreign currency translations are presented as other in the above table. Also included within other are transfers between business segments due to reorganizations.

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**NOTE 9 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
	September 30,			June 30,		
	2010			2010		
Contract-based	\$ 1,067	\$ (921)	\$ 146	\$ 1,075	\$ (914)	\$ 161
Technology-based	2,283	(1,544)	739	2,308	(1,521)	787
Marketing-related	112	(87)	25	114	(86)	28
Customer-related	390	(223)	167	390	(208)	182
Total	\$ 3,852	\$ (2,775)	\$ 1,077	\$ 3,887	\$ (2,729)	\$ 1,158

Intangible assets amortization expense was \$124 million and \$149 million for the three months ended September 30, 2010 and 2009, respectively. The following table outlines the estimated future amortization expense related to intangible assets held at September 30, 2010:

(In millions)

**Year Ending June 30,**

2011 (excluding the three months ended September 30, 2010)	\$ 374
2012	383
2013	244
2014	49
2015	11
2016 and thereafter	16
Total	\$ 1,077

**NOTE 10 DEBT**

In September 2010, we issued \$4.75 billion of debt securities. See further discussion of these securities under Notes below. As of September 30, 2010, we had \$10.7 billion of issued and outstanding debt comprising \$1.0 billion of commercial paper and \$9.7 billion of long-term debt, including \$1.3 billion of convertible debt.

**Short-term Debt**



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As of September 30, 2010, our \$1.0 billion of commercial paper issued and outstanding had a weighted average interest rate, including issuance costs, of 0.19% and maturities of 29 to 42 days. The estimated fair value of this commercial paper approximates its carrying value.

We have a \$1.0 billion 364-day credit facility, which expires on November 5, 2010, and which serves as a back-up for our commercial paper program. As of September 30, 2010, we were in compliance with the financial covenant in the credit facility agreement, which requires a coverage ratio be maintained of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facility during any of the periods presented.

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**Long-term Debt***Notes*

As of September 30, 2010, we had issued and outstanding \$8.5 billion of debt securities as illustrated in the table below (collectively the Notes), including \$4.75 billion of debt securities issued in September 2010. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

*Convertible Debt*

In June 2010, we issued \$1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were \$1.24 billion, net of fees and expenses, which were capitalized. Each \$1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of \$33.40 per share.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft's common stock or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of \$1.24 billion were allocated between debt for \$1.18 billion and stockholders' equity for \$58 million with the portion in stockholders' equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with a cap price equal to \$37.16. The purchased capped calls were valued at \$40 million and recorded to stockholders' equity.

As of September 30, 2010, the total carrying value and estimated fair value of our long-term debt, including convertible debt, were \$9.7 billion and \$10.1 billion, respectively. The estimated fair value is based on quoted prices for our publicly-traded debt as of September 30, 2010, as applicable.

The components of long-term debt as of September 30, 2010 were as follows:

(In millions)

Zero coupon convertible notes due on June 15, 2013	\$ 1,250
0.875% Notes due on September 27, 2013	1,000
2.95% Notes due on June 1, 2014	2,000
1.625% Notes due on September 25, 2015	1,750
4.20% Notes due on June 1, 2019	1,000
3.0% Notes due on October 1, 2020	1,000

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5.20% Notes due on June 1, 2039	<b>750</b>
4.5% Notes due on October 1, 2040	<b>1,000</b>
Unamortized discount	<b>(85)</b>
<hr/>	
Total	<b>\$ 9,665</b>
<hr/>	

Interest on the 2013 Notes is payable semi-annually on March 27 and September 27 of each year to holders of record on the preceding March 15 and September 15. Interest on the 2014, 2019 and 2039 Notes is payable semi-annually on June 1 and December 1 of each year to holders of record on the preceding May 15 and November 15. Interest on the 2015 Notes is payable semi-annually on March 25 and September 25 of each year to holders of record on the preceding March 15 and September 15. Interest on the 2020 and 2040 Notes is payable semi-annually on April 1 and October 1 of each year to holders of record on the preceding March 15 and September 15.

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**NOTE 11 INCOME TAXES**

Our effective tax rates were approximately 25% for the three months ended September 30, 2010 and 2009. Tax contingencies and other tax liabilities were \$6.7 billion as of September 30, 2010 and \$6.9 billion as of June 30, 2010, and were included in other long-term liabilities.

**NOTE 12 UNEARNED REVENUE**

The components of unearned revenue were as follows:

(In millions)

	September 30, 2010	June 30, 2010
Volume licensing programs	\$ 11,380	\$ 12,180
Undelivered elements	514	624
Other	2,025	2,026
Total	<u>\$ 13,919</u>	<u>\$ 14,830</u>

Unearned revenue by segment was as follows:

(In millions)

	September 30, 2010	June 30, 2010
Windows & Windows Live Division	\$ 1,570	\$ 1,701
Server and Tools	4,987	5,282
Microsoft Business Division	6,573	7,004
Other segments	789	843
Total	<u>\$ 13,919</u>	<u>\$ 14,830</u>

**NOTE 13 COMMITMENTS AND GUARANTEES****Yahoo! Commercial Agreement**

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On December 4, 2009, we entered into a definitive agreement with Yahoo! whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. The term of the agreement is 10 years subject to termination provisions after five years based on performance.

Microsoft provided Yahoo! with revenue per search guarantees for a period of 18 months after implementation of the Microsoft search ads platform in each country. These guarantees are calculated, paid and true-up periodically based on the cumulative reduction in revenue per search, if any, during the 18 month period from pre-implementation levels, except in the case of the U.S. and Canada where performance during each of the first two calendar quarters after implementation is independent and not cumulative. This is a rate guarantee and not a guarantee of search volume. We estimate the total cost of the revenue per search guarantees during the guarantee period could range between zero and \$150 million; however, no amount has been recorded for the revenue per search guarantees as we do not believe that such liability exists at this time.

Microsoft also agreed to reimburse Yahoo! for certain transition expenses incurred both before and after the effective date of the agreement.

Finally, Microsoft also agreed to reimburse Yahoo! for certain costs of running algorithmic and paid search services prior to migration to Microsoft's platform.

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**Product Warranty**

Our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities, changed during the three months ended September 30, 2010 as follows:

(In millions)

Balance, beginning of period	\$ 240
Accrual for warranties issued	13
Settlements of warranty claims	(39)
Balance, end of period	<u>\$ 214</u>

**NOTE 14 CONTINGENCIES****Government Competition Law Matters**

We are subject to a Consent Decree and Final Judgment ( Final Judgments ) that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Final Judgments imposed various constraints on our Windows operating system businesses. The Final Judgments are scheduled to expire in May 2011.

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 were 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.

The settlements in all states have received final court approval. 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 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. We estimate the total cost to resolve all of the state overcharge class action cases will range between \$1.9 billion and \$2.0 billion. At September 30, 2010, we have recorded a liability related to these claims of approximately \$621 million, which reflects our estimated exposure of \$1.9 billion less payments made to date of approximately \$1.2 billion mostly for vouchers, legal fees, and administrative expenses.

The three cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In March 2010, the court in the British Columbia case certified it as a class action. We have appealed this ruling. The other two actions have been stayed.

**Other Antitrust Litigation and Claims**

In November 2004, Novell, Inc. filed a complaint in U.S. District Court for the District of Utah (later transferred to federal court in Maryland), 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. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. In March 2010 the trial court granted summary judgment in favor of Microsoft as to all remaining claims. Novell has appealed that ruling.

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### **Patent and Intellectual Property Claims**

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 (although this action began before the merger of Alcatel and Lucent in 2006, for simplicity we refer to the post-merger entity of Alcatel-Lucent). 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 we 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. We appealed that award to the Federal Circuit. In December 2008, we entered into a settlement agreement resolving all other litigation pending between Microsoft and Alcatel-Lucent, leaving approximately \$500 million remaining in dispute. In September 2009, the United States Court of Appeals for the Federal Circuit affirmed the liability award but vacated the verdict and remanded the case to the trial court for a re-trial of the damages ruling, indicating the damages previously awarded were too high. Trial on the remanded damages claim has been set for the first week of December 2010.

In October 2003, Uniloc USA Inc., a subsidiary of a Singapore-based security technology company, filed a patent infringement suit in U.S. District Court in Rhode Island, claiming that product activation technology in Windows XP and certain other Microsoft programs violated a Uniloc patent. After we obtained a favorable summary judgment that we did not infringe any of the claims of this patent, the court of appeals vacated the trial court decision and remanded the case for trial. In April 2009, the jury returned a \$388 million verdict against us, including a finding of willful infringement. In September 2009, the district court judge overturned the jury verdict, ruling that the evidence did not support the jury's finding that Microsoft infringed the patent. Uniloc has appealed.

In March 2007, i4i Limited Partnership sued Microsoft in U.S. District Court in Texas claiming that certain custom XML technology in Word 2003 and 2007 infringed i4i's patent. In May 2009, a jury returned a verdict against us, finding damages of \$200 million and that we willfully infringed the patent. In August 2009, the court denied our post-trial motions and awarded enhanced damages of \$40 million and prejudgment interest of \$37 million. The court also issued a permanent injunction prohibiting additional distribution of the allegedly infringing technology. We appealed and the appellate court stayed the injunction pending our appeal. In December 2009, the court of appeals rejected our appeal and affirmed the trial court's judgment and injunction, except that the court of appeals modified the effective date of the injunction to January 11, 2010. In April 2010, the court of appeals denied our request for a rehearing. In August, 2010, we filed a petition seeking review by the U.S. Supreme Court.

In addition to these cases, there are approximately 40 other patent infringement cases pending against Microsoft.

### **Other**

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

As of September 30, 2010, we had accrued aggregate liabilities of \$870 million in other current liabilities and \$375 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 reach approximately \$1.0 billion in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.

### **NOTE 15 STOCKHOLDERS' EQUITY**

#### **Share Repurchases**

We repurchased the following shares of common stock during the periods presented:



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(In millions)

Three Months Ended September 30,	2010	2009
Shares of common stock repurchased	163	58
Value of common stock repurchased	\$ 4,000	\$ 1,445

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We repurchased all shares with cash resources. As of September 30, 2010, approximately \$19.7 billion remained of our \$40.0 billion repurchase program that we announced on September 22, 2008. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

**Dividends**

Our Board of Directors declared the following dividends during the periods presented:

<b>Declaration Date</b>	<b>Per Share Dividend</b>	<b>Record Date</b>	<b>Total Amount</b>	<b>Payment Date</b>
(in millions)				
September 21, 2010	\$ 0.16	November 18, 2010	\$ 1,370	December 9, 2010
September 18, 2009	\$ 0.13	November 19, 2009	\$ 1,152	December 10, 2009

The estimate of the amount to be paid as a result of the September 21, 2010 declaration was included in other current liabilities as of September 30, 2010.

**NOTE 16 SEGMENT INFORMATION**

In its operation of the business, management, including our chief operating decision maker, the Company's Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segment information within this note is reported on that basis. Our five segments are Windows & Windows Live Division; Server and Tools; Online Services Division; Microsoft Business Division; and Entertainment and Devices Division.

Due to the integrated structure of our business, certain revenue earned and costs incurred by one segment may benefit other segments. Revenue on certain contracts may be allocated among the segments based on the relative value of the underlying products and services. Costs that are identifiable are allocated to the segments that benefit to incent cross-collaboration among our segments so that one segment is not solely burdened by the cost of a mutually beneficial activity. Allocated costs may include those relating to development and marketing of products and services from which multiple segments benefit, or those costs relating to services performed by one segment on behalf of other segments. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated.

In addition, certain costs incurred at a corporate level that are identifiable and that benefit our segments are allocated to them. These allocated costs include costs of: field selling; employee benefits; shared facilities services; and customer service and support. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated. Certain other corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; legal settlements and contingencies; and employee severance.

We have recast certain prior period amounts within this note to conform to the way we internally managed and monitored segment performance during the current fiscal year.



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

(In millions)

Three Months Ended September 30,	2010	2009
<b>Revenue</b>		
Windows & Windows Live Division	\$ 4,705	\$ 4,240
Server and Tools	3,961	3,552
Online Services Division	527	487
Microsoft Business Division	5,097	4,517
Entertainment and Devices Division	1,769	1,412
Unallocated and other	136	(1,288)
Consolidated	<u>\$ 16,195</u>	<u>\$ 12,920</u>
<b>Operating income (loss)</b>		
Windows & Windows Live Division	\$ 3,206	\$ 2,822
Server and Tools	1,584	1,180
Online Services Division	(579)	(496)
Microsoft Business Division	3,321	2,792
Entertainment and Devices Division	360	245
Reconciling amounts	(776)	(2,061)
Consolidated	<u>\$ 7,116</u>	<u>\$ 4,482</u>

Reconciling amounts in the tables above and below include adjustments to conform our internal accounting policies to U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, depreciation, and amortization of stock-based awards.

Significant reconciling items were as follows:

(In millions)

Three Months Ended September 30,	2010	2009
Corporate-level activity <sup>(a)</sup>	\$ (1,047)	\$ (848)
Stock-based compensation	179	160
Revenue reconciling amounts	133	(1,365)
Other	(41)	(8)
Total	<u>\$ (776)</u>	<u>\$ (2,061)</u>

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(a) *Corporate-level activity excludes stock-based compensation and revenue reconciling amounts presented separately in those line items.* Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each segment and it is impracticable for us to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation ) as of September 30, 2010, and the related consolidated statements of income, cash flows, and stockholders' equity for the three-month periods ended September 30, 2010 and 2009. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2010, and the related consolidated statements of income, cash flows, and stockholders' equity for the year then ended (not presented herein); and in our report dated July 30, 2010 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2010 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington

October 28, 2010

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

**Note About Forward-Looking Statements**

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including without limitation, the following sections: Business, Management's Discussion and Analysis, and Risk Factors. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, will likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled Risk Factors (refer to Part II, Item 1A of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

**OVERVIEW**

Management's discussion and analysis is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended June 30, 2010 and the Consolidated Financial Statements and accompanying notes (Notes) included in this Form 10-Q.

We generate revenue by developing, manufacturing, licensing, and supporting a wide range of software products and services for many different types of computing devices. Our software products and services include operating systems for personal computers, servers, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solutions applications; high-performance computing applications; software development tools; and video games. We provide consulting and product and solution support services, and we train and certify computer system integrators and developers. We also design and sell hardware, including the Xbox 360 gaming and entertainment console and accessories, the Zune digital music and entertainment device and accessories, and Microsoft PC hardware products. Online offerings and information are delivered to consumers through Bing, Windows Live, Microsoft Office Web Apps, our MSN portals and channels, and to businesses through Microsoft Online Services offerings, such as Microsoft Dynamics CRM Online, Exchange Online, Windows Azure, SQL Azure and SharePoint Online. We enable the delivery of online advertising across our broad range of digital media properties and on Bing through our proprietary adCenter platform.

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated approximately 40% of its yearly segment revenues in our second fiscal quarter. In addition, quarterly revenues may be impacted by the deferral of revenue. See the discussions below regarding the deferral of revenue related to sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost and of Windows 7 to retailers before general availability (the Windows 7 Deferral).

All growth and percentage comparisons refer to the three months ended September 30, 2010, as compared with the three months ended September 30, 2009, unless otherwise noted.





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**Summary**

(In millions, except per share amounts and percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Revenue	\$ 16,195	\$ 12,920	25%
Operating income	\$ 7,116	\$ 4,482	59%
Diluted earnings per share	\$ 0.62	\$ 0.40	55%

Revenue increased primarily due to strong sales of Windows 7, the 2010 Microsoft Office system, Server and Tools products, and the Xbox 360 console and video games. Revenue also increased due to the deferral in the prior year of approximately \$1.5 billion of revenue related to the Windows 7 Deferral. Changes in foreign currency exchange rates had an insignificant impact on revenue.

Operating income increased reflecting the change in revenue, offset in part by higher operating expenses. Key changes in operating expenses were:

Cost of revenue increased \$297 million or 10%, primarily reflecting higher online costs and increased volumes of Xbox 360 consoles sold.

General and administrative expenses increased \$197 million or 27%, due mainly to increased legal charges and headcount-related expenses.

Research and development expenses increased \$131 million or 6%, due mainly to higher headcount-related expenses and third-party development and programming costs.

Diluted earnings per share increased reflecting increased net income and the repurchase of 485 million shares during the 12 months ended September 30, 2010.

Global macroeconomic factors have a strong correlation to demand for our software, services, hardware, and online offerings. The current macroeconomic factors remain dynamic and uncertain. Irrespective of global economic conditions, we are positive about our relative market position, our current product portfolio, and future product pipeline. Because we offer a wide range of products and services that enable companies to improve productivity and reduce costs, including cloud-based services, we believe that Microsoft is well-positioned to create new opportunities to increase revenue as the global economy improves. We remain focused on executing in the areas we can control by continuing to provide high value products at the lowest total cost of ownership while managing our expenses.

**SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)**

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the U.S. ( U.S. GAAP ) and include certain reconciling items attributable to each of the segments. Segment information appearing in

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Note 16 Segment Information of the Notes to Financial Statements (Part I, Item I of this Form 10-Q) is presented on a basis consistent with our current internal management reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. We have recast certain prior period amounts within this MD&A to conform to the way we internally managed and monitored segment performance during the current fiscal year.

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**Windows & Windows Live Division**

	<b>Three Months Ended</b>		<b>Percentage</b>
<b>(In millions, except percentages)</b>	<b>September 30,</b>		<b>Change</b>
	<b>2010</b>	<b>2009</b>	
Revenue	\$ 4,785	\$ 2,880	66%
Operating income	\$ 3,323	\$ 1,483	124%

Windows & Windows Live Division ( Windows Division ) offerings consist of premium and standard edition Windows operating systems, and online software and services through Windows Live. Premium Windows operating systems are those that include additional functionality and are sold at a price above our standard editions. Premium editions include Windows 7 Home Premium, Professional, Ultimate, and Enterprise, as well as Windows Vista Business, Home Premium, Ultimate, and Enterprise. Standard editions include Windows 7 Starter and Home Basic, Windows Vista Starter and Home Basic, and Windows XP Home. Windows Live primarily generates revenue from online advertising.

Windows Division revenue growth is largely correlated to the growth of PC purchases from original equipment manufacturers ( OEMs ) that pre-install versions of Windows operating systems because the OEM channel accounts for approximately 75% of total Windows Division revenue. The remaining approximately 25% of Windows Division revenue ( other revenue ) is generated by commercial and retail sales of Windows and online advertising from Windows Live.

Windows Division revenue increased due to strong sales of Windows 7 and PC market growth. We estimate total worldwide PC shipments from all sources grew approximately 9% to 11%. OEM revenue increased \$1.8 billion or 93%. Including revenue and units associated with the Windows 7 Deferral in the prior year, OEM revenue increased \$364 million or 11%, while OEM license units increased 5%. The OEM revenue increase was driven by PC market growth, PC market strength among business customers, and the mix of versions of Windows licensed, partially offset by lower Windows attach rates in China and year-over-year changes in inventory in our distribution channels. Other revenue increased \$125 million or 13%, driven primarily by commercial and retail sales of Windows 7.

Windows Division operating income grew as a result of increased revenue, offset in part by higher operating expenses. Cost of revenue increased \$22 million or 5%, primarily driven by higher traffic acquisition and royalty costs. Sales and marketing expenses increased \$22 million or 4% reflecting advertising and marketing of Windows and Windows Live.

**Server and Tools**

	<b>Three Months Ended</b>		<b>Percentage</b>
<b>(In millions, except percentages)</b>	<b>September 30,</b>		<b>Change</b>
	<b>2010</b>	<b>2009</b>	
Revenue	\$ 3,959	\$ 3,550	12%
Operating income	\$ 1,630	\$ 1,237	32%

Server and Tools licenses products, applications, tools, content, and delivers Enterprise Services, all of which are designed to make information technology professionals, developers and their systems more productive and efficient. Server and Tools product and service offerings consist of Windows Server, Microsoft SQL Server, Windows Azure and other cloud and server offerings, and Windows Embedded device platforms. We also offer developer tools, training and certification. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. Server product offerings can be run on-site, in a partner-hosted environment, or in a Microsoft-hosted environment. We use multiple sales channels, including pre-installed OEM versions, sales through partners and sales directly to end customers. Approximately 50% of Server and Tools revenue comes from annuity volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

Server and Tools revenue increased reflecting growth in product revenue and Enterprise Services revenue. Product revenue increased \$343 million or 12%, driven primarily by growth in Windows Server, SQL Server, Enterprise CAL Suites and Windows Embedded revenue, reflecting continued adoption of Windows platform applications. Enterprise Services revenue grew \$66 million or 9%, due to growth in both Premier product support services and consulting services.

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Server and Tools operating income increased primarily due to revenue growth, offset in part by a slight increase in operating expenses. Cost of revenue increased \$55 million or 8%, reflecting higher costs associated with the delivery of services and online costs. Sales and marketing expenses decreased \$38 million or 4%, primarily due to lower corporate marketing and advertising expenses.

**Online Services Division**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Revenue	\$ 527	\$ 487	8%
Operating loss	\$ (560)	\$ (477)	(17)%

Online Services Division ( OSD ) offerings include Bing, MSN, and advertiser and publisher tools.

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew \$55 million or 13% to \$473 million, reflecting higher search and owned and operated display advertising revenue, offset in part by decreased third party advertising revenue.

OSD operating loss increased due to higher cost of revenue and research and development expenses, offset in part by increased revenue. Cost of revenue grew \$74 million driven by costs associated with the Yahoo! search agreement, partially offset by decreased online traffic acquisition costs. Research and development expenses increased \$61 million or 27%, primarily due to headcount-related expenses related to the search portion of the business.

**Microsoft Business Division**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Revenue	\$ 5,126	\$ 4,514	14%
Operating income	\$ 3,388	\$ 2,827	20%

Microsoft Business Division ( MBD ) offerings include the Microsoft Office system and Microsoft Dynamics business solutions. Microsoft Office system products are designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions. Microsoft Office system offerings generate over 90% of MBD revenue. Microsoft Dynamics products provide business solutions for financial management, customer relationship management, supply chain management, and analytics applications. We evaluate our results based upon the nature of the end user in two primary parts: business revenue, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue; and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

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MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system, which was released during the fourth quarter of fiscal year 2010. Business revenue increased \$396 million or 11%, primarily reflecting licensing of the 2010 Microsoft Office system to transactional business customers, growth in multi-year licensing revenue, and a 4% increase in Microsoft Dynamics revenue. Consumer revenue increased \$216 million or 26% due to sales of the 2010 Microsoft Office system and growth in the PC market.

MBD operating income increased due mainly to revenue growth, offset in part by higher cost of revenue. Cost of revenue increased \$81 million or 30%, primarily driven by higher costs of providing services and increased traffic acquisition costs.

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**Entertainment and Devices Division**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Revenue	\$ 1,795	\$ 1,412	27%
Operating income	\$ 382	\$ 260	47%

Entertainment and Devices Division ( EDD ) offerings include the Xbox 360 platform (which includes the Xbox 360 gaming and entertainment console, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories, including Kinect for Xbox 360 launching in November 2010), the Zune digital music and entertainment platform, PC game software, online games and services, Mediaroom (our Internet protocol television software), and Windows Phone.

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue. Xbox 360 platform revenue grew \$409 million or 33%, primarily reflecting increased volumes of Xbox 360 consoles sold and higher Xbox 360 video game revenue led by Halo Reach. We shipped 2.8 million Xbox 360 consoles during the first quarter of fiscal year 2011, compared with 2.1 million Xbox 360 consoles during the first quarter of fiscal year 2010. Halo Reach launched in September 2010 generating approximately \$350 million of revenue during the quarter.

EDD operating income increased primarily reflecting revenue growth, offset in part by higher operating expenses. Cost of revenue increased \$152 million or 19% primarily due to higher volumes of Xbox 360 consoles sold. Research and development expenses increased \$65 million or 30%, primarily reflecting higher headcount-related expenses. Sales and marketing expenses increased \$39 million or 27% due mainly to increased Xbox 360 platform marketing activities.

**Corporate-Level Activity**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Corporate-level activity	\$ (1,047)	\$ (848)	(23)%

Certain corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; and legal settlements and contingencies. Corporate-level expenses increased due mainly to a \$113 million increase in legal charges and a 6% increase in headcount-related expenses.

**OPERATING EXPENSES****Cost of Revenue**

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(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Cost of revenue	\$ 3,139	\$ 2,842	10%
As a percent of revenue	19%	22%	(3)ppt

Cost of revenue includes: manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our Web sites and to acquire online advertising space ( traffic acquisition costs ); costs incurred to support and maintain Internet-based products and services; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs. Cost of revenue increased primarily due to higher online costs and increased volumes of Xbox 360 consoles sold.



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**Research and Development**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Research and development	\$ 2,196	\$ 2,065	6%
As a percent of revenue	14%	16%	(2)ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Research and development expenses increased, primarily reflecting a 5% increase in headcount-related expenses and higher third-party development and programming costs.

**Sales and Marketing**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Sales and marketing	\$ 2,806	\$ 2,790	1%
As a percent of revenue	17%	22%	(5)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and the costs of advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses increased slightly, primarily reflecting increased advertising and marketing of Windows and Windows Live and the Xbox 360 platform, offset in part by decreased corporate marketing and advertising expenses.

**General and Administrative**

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
General and administrative	\$ 938	\$ 741	27%
As a percent of revenue	6%	6%	0ppt

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General and administrative expenses include payroll, employee benefits, stock-based compensation expense and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative headcount, and legal and other administrative fees. General and administrative expenses increased primarily due to increased legal charges, as discussed under Corporate-Level Activity above, and an increase in headcount-related expenses.

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**OTHER INCOME AND INCOME TAXES****Other Income**

The components of other income were as follows:

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2010	2009	
Dividends and interest income	\$ 210	\$ 203	3%
Interest expense	(45)	(38)	(18)%
Net recognized gains on investments	34	70	(51)%
Net losses on derivatives	(5)	(4)	(25)%
Net gains (losses) on foreign currency remeasurements	(42)	55	*
Other	(38)	(3)	*
Total	\$ 114	\$ 283	(60)%

\* *Not meaningful*

Dividends and interest income increased slightly due to higher average portfolio investment balances, offset in part by lower yields on our fixed-income investments. Interest expense increased due to our increased issuance of debt. Net recognized gains on investments decreased primarily due to fewer gains on sales of investments in the current period as compared to the prior period. Net losses on foreign currency remeasurements increased primarily due to currency movements net of our hedging activities.

**Income Taxes**

Our effective tax rates were approximately 25% for the three months ended September 30, 2010 and 2009.

**FINANCIAL CONDITION****Cash, Cash Equivalents, and Investments**

Cash, cash equivalents, and short-term investments totaled \$44.2 billion as of September 30, 2010, compared with \$36.8 billion as of June 30, 2010. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of investment grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities in order to diversify risk. Equity and other investments were \$9.2 billion as of September 30, 2010, compared with \$7.8 billion as of June 30, 2010.

While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of September 30, 2010 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of our mortgage-backed

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securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was \$909 million as of September 30, 2010. Our average and maximum securities lending payable balances for the three months ended September 30, 2010 were \$1.7 billion and \$2.6 billion, respectively. Intra-quarter variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

### *Valuation*

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our financial instruments. This pricing methodology applies to our Level 1 investments,

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such as exchange-traded mutual funds, domestic and international equities, and U.S. treasuries. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government bonds, mortgage-backed securities, and agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured using unobservable inputs are an immaterial portion of our portfolio.

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

#### **Debt**

In September 2010, we issued \$4.75 billion of debt securities. See further discussion of these securities under **Notes** below. As of September 30, 2010, we had \$10.7 billion of issued and outstanding debt comprising \$1.0 billion of commercial paper and \$9.7 billion of long-term debt, including \$1.3 billion of convertible debt.

##### *Short-term Debt*

As of September 30, 2010, our \$1.0 billion of commercial paper issued and outstanding had a weighted average interest rate, including issuance costs, of 0.19% and maturities of 29 to 42 days. The estimated fair value of this commercial paper approximates its carrying value.

We have a \$1.0 billion 364-day credit facility, which expires on November 5, 2010, and which serves as a back-up for our commercial paper program. As of September 30, 2010, we were in compliance with the financial covenant in the credit facility agreement, which requires a coverage ratio be maintained of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facility during any of the periods presented.

##### *Long-term Debt*

#### **Notes**

As of September 30, 2010, we had issued and outstanding \$8.5 billion of debt securities as follows: \$1.0 billion aggregate principal amount of 0.875% notes due 2013, \$2.0 billion aggregate principal amount of 2.95% notes due 2014, \$1.75 billion aggregate principal amount of 1.625% notes due 2015, \$1.0 billion aggregate principal amount of 4.20% notes due 2019, \$1.0 billion aggregate principal amount of 3.0% notes due 2020, \$750 million aggregate principal amount of 5.20% notes due 2039, and \$1.0 billion aggregate principal amount of 4.5% notes due 2040, (collectively the **Notes**). The **Notes** are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

#### **Convertible Debt**

In June 2010, we issued \$1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were \$1.24 billion, net of fees and expenses, which were capitalized. Each \$1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of \$33.40 per share.



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Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft's common stock or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of \$1.24 billion were allocated between debt for \$1.18 billion and stockholders' equity for \$58 million with the portion in stockholders' equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with a cap price equal to \$37.16. The purchased capped calls were valued at \$40 million and recorded to stockholders' equity.

**Unearned Revenue**

Unearned revenue at September 30, 2010 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each billing coverage period and accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at September 30, 2010 also included payments for: post-delivery support and consulting services to be performed in the future, Xbox LIVE subscriptions; Microsoft Dynamics business solutions products; unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis for Windows XP; technology guarantee programs, including the 2010 Microsoft Office technology guarantee program; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of September 30, 2010:

(In millions)

**Three Months Ending,**

December 31, 2010	\$ 5,694
March 31, 2011	3,939
June 30, 2011	2,347
September 30, 2011	787
Thereafter	1,152
<b>Total</b>	<b>\$ 13,919</b>

**Cash Flows**

Cash flows from operations increased \$2.1 billion to \$8.2 billion due mainly to increased revenue and cash collections, partially offset by a decrease in unearned revenue. Cash used in financing decreased \$1.6 billion to \$639 million due mainly to \$4.7 billion of proceeds from

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issuances of long-term debt in the current quarter, partially offset by a \$2.9 billion increase in common stock repurchases. Cash used in investing increased \$3.8 billion to \$5.0 billion due mainly to a \$2.5 billion increase in cash used for combined investment purchases, sales, and maturities and a \$1.1 billion decrease in cash from securities lending.

### **Share Repurchases**

During the three months ended September 30, 2010, we repurchased approximately 163 million shares of Microsoft common stock for \$4.0 billion under the repurchase plan we announced on September 22, 2008. All repurchases



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were made using cash resources. As of September 30, 2010, approximately \$19.7 billion remained of the \$40.0 billion approved repurchase amount. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

**Dividends**

Our Board of Directors declared the following dividends during the periods presented:

<b>Declaration Date</b>	<b>Per Share Dividend</b>	<b>Record Date</b>	<b>Total Amount</b>	<b>Payment Date</b>
(in millions)				
September 21, 2010	\$ 0.16	November 18, 2010	\$ 1,370	December 9, 2010
September 18, 2009	\$ 0.13	November 19, 2009	\$ 1,152	December 10, 2009

**Off-Balance Sheet Arrangements**

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. In evaluating estimated losses on these indemnifications, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. To date, we have not encountered significant costs as a result of these obligations and have not accrued any liabilities related to these indemnifications in our financial statements.

**Other Planned Uses of Capital**

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

We believe existing cash, cash equivalents and short-term investments, together with funds generated from operations, should be sufficient to meet operating requirements, regular quarterly dividends, debt repayment schedules, and share repurchases. Our philosophy regarding the maintenance of a balance sheet with a large component of cash and cash equivalents, short-term investments, and equity and other investments, reflects our views on potential future capital requirements relating to research and development, creation and expansion of sales distribution channels, investments and acquisitions, share dilution management, legal risks, and challenges to our business model. We regularly assess our investment management approach in view of our current and potential future needs. We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. While we currently do not foresee a need to repatriate funds, should we require more capital in the U.S. than is generated by our operations locally, we could elect to repatriate funds held in foreign jurisdictions or raise capital in the U.S. through debt or equity issuances. These alternatives could result in higher effective tax rates or increased interest expense.

As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was \$15.0 billion at September 30, 2010. Our retained deficit is not expected to affect our future ability to operate, pay dividends, or repay our debt given our continuing profitability and strong cash and financial position.

**RECENT ACCOUNTING GUIDANCE**

**Recently Adopted Accounting Guidance**

On July 1, 2010, we adopted guidance issued by the Financial Accounting Standards Board ( FASB ) on revenue recognition. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product are no longer within the scope of

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the software revenue recognition guidance, and software-enabled products are now subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2010, we adopted new guidance issued by the FASB on the consolidation of variable interest entities. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. Adoption of the new guidance did not have a material impact on our financial statements.

#### **Recent Accounting Guidance Not Yet Adopted**

In January 2010, the FASB issued guidance to amend the disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on our financial statements.

### **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

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

#### **Revenue Recognition**

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence ( VSOE ) of fair value exists for those elements. A portion of revenue may be recorded as unearned due to undelivered elements. The amount of revenue allocated to undelivered elements is based on the VSOE of fair value for those elements using the residual method or relative fair value method, and the deferred revenue is recognized as the elements are delivered. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

#### **Impairment of Investment Securities**

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



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#### **Goodwill**

Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit. We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach.

#### **Research and Development Costs**

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

#### **Legal and Other Contingencies**

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial statements.

#### **Income Taxes**

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

#### **Stock-Based Compensation**

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Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be impacted.

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#### **Product Warranties**

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

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### **RISKS**

We are exposed to economic risk from foreign currency exchange rates, interest rates, credit risk, equity prices, and commodity prices. A portion of these risks is hedged, but they may impact our financial statements.

#### **Foreign Currency**

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily and use hedges where practicable to offset the risks and maximize the economic effectiveness of our foreign currency positions. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar.

#### **Interest Rate**

Our fixed-income portfolio is diversified across credit sectors and maturities, consisting primarily of investment-grade securities. The credit risk and average maturity of the fixed-income portfolio is managed to achieve economic returns that correlate to certain global and domestic fixed-income indices. In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency and mortgage-backed securities.

#### **Equity**

Our equity portfolio consists of global, developed, and emerging market securities that are subject to market price risk. We manage the securities relative to certain global and domestic indices and expect their economic risk and return to correlate with these indices.

#### **Commodity**

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

#### **VALUE-AT-RISK**

We use a value-at-risk ( VaR ) model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in the fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model is not intended to represent actual losses in fair value, including determinations of other-than-temporary losses in fair value in accordance with accounting principles generally accepted in the United States ( U.S. GAAP ), but is used as a risk estimation and management tool. The distribution of the potential changes in total market

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value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

The VaR is calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured



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in the model, including liquidity risk, operational risk, and legal risk. The following table sets forth the one-day VaR for substantially all of our positions as of September 30, 2010 and June 30, 2010 and for the three months ended September 30, 2010:

(In millions)

Risk Categories	September 30, 2010	June 30, 2010	Three Months Ended September 30, 2010		
			Average	High	Low
Foreign currency	\$ 51	\$ 57	\$ 58	\$ 75	\$ 46
Interest rate	\$ 53	\$ 58	\$ 53	\$ 58	\$ 50
Equity	\$ 212	\$ 183	\$ 197	\$ 212	\$ 184
Commodity	\$ 19	\$ 19	\$ 19	\$ 22	\$ 18

Total one-day VaR for the combined risk categories was \$253 million at September 30, 2010 and \$235 million at June 30, 2010. The total VaR is 25% less at September 30, 2010, and 26% less at June 30, 2010, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

See Note 14 Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding certain legal proceedings in which we are involved.

**ITEM 1A. RISK FACTORS**

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

**The cloud-based computing model presents execution and competitive risks.** We are transitioning to a computing environment characterized by cloud-based services used with smart client devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud. We are devoting significant resources to develop and deploy our own competing cloud-based software plus services strategies. While we believe our expertise, investments in infrastructure, and the breadth of our cloud-based services provides us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to

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software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

continuing to innovate and bring to market compelling cloud-based experiences that generate increasing traffic and market share;

maintaining the utility, compatibility and performance of our cloud-based services on the growing array of computing devices, including smartphones, handheld computers, netbooks, tablets and television set top devices; and

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continuing to enhance the attractiveness of our cloud platforms to third-party developers.

**Challenges to our business models may reduce our revenues or operating margins.** Whether our software runs in the cloud or on a device, we continue to face challenges from alternative means of developing and licensing software. Under our license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. Certain open source software business models challenge our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not bear the full costs of research and development for the software. In some cases, their products may infringe patents granted to Microsoft for our inventions. In addition, advertising-based business models seek revenue by delivering third party advertisements to end customers who receive the software and services at no direct costs. Gains in market acceptance of open source or advertising based software may adversely affect our sales, revenue, and operating margins.

An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A competing vertically-integrated model, in which a single firm controls both the software and hardware elements of a product, has been successful with certain consumer products such as personal computers, mobile phones, and digital music players. We also offer vertically-integrated hardware and software products; however, efforts to compete with the vertically integrated model may increase our cost of sales and reduce our operating margins.

We derive substantial revenue from licenses of Windows operating systems on personal computers. It is uncertain to what extent alternative devices and form factors will increase the number of computing devices that users own or will substitute for users' personal computer purchases. Alternative devices also run operating systems and applications developed by our competitors. These factors could impact our revenues and margins.

**We face intense competition.** We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio is a competitive advantage, our competitors that are focused on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products, in some cases in violation of our intellectual property rights or on the basis of technical specifications for Microsoft technologies that we make available at little or no cost in connection with our interoperability initiatives. In response to competition, we continue to develop versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins, and operating income.

**We may not be able to adequately protect our intellectual property rights.** Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. As a result, our revenue in these markets likely will grow slower than the underlying PC market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

**Third parties may claim we infringe their intellectual property rights.** From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. To resolve these claims we may enter into royalty and licensing agreements on less favorable terms, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to

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settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

**We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code.** Source code, the detailed program commands for our operating systems and other software programs, is

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critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. This could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code also could increase the security risks described in the next paragraph.

**Security vulnerabilities in our products and services could lead to reduced revenues or to liability claims.** Maintaining the security of computers and computer networks is a critical issue for us and our customers. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products and gain access to our networks and data centers. Although this is an industry-wide problem that affects computers across all platforms, it affects our products in particular because hackers tend to focus their efforts on the most popular operating systems and programs and we expect them to continue to do so. We devote significant resources to address security vulnerabilities through:

engineering more secure products and services;

enhancing security and reliability features in our products and services;

helping our customers make the best use of our products and services to protect against computer viruses and other attacks;

improving the deployment of software updates to address security vulnerabilities;

investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed; and

providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, if third parties gain access to our networks or data centers they could obtain and exploit confidential business information and harm our competitive position. Finally, actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges.

**Improper disclosure of personal data could result in liability and harm our reputation.** We store and process large amounts of personally identifiable information as we sell software, provide support and offer cloud-based services to customers. It is possible that our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information. Improper disclosure of this information could harm our reputation, lead to legal exposure to customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data. Perceptions that our products or services do not adequately protect the privacy of personal information could inhibit sales of our products or services.

**We may experience outages, data loss and disruptions of our online services if we fail to maintain an adequate operations infrastructure.** Our increasing user traffic and complexity of our products and services demand more computing power. We have spent and expect to continue to spend substantial amounts to purchase or lease data centers and equipment and to upgrade our technology and network infrastructure to handle increased traffic on our Web sites and in our data centers, and to introduce new products and services and support existing services such as Bing, Exchange Online, SharePoint Online, Xbox LIVE, Windows Live, and Microsoft Office Web Apps. We also are growing our business of providing a platform and back-end hosting for services provided by third-party businesses to their end customers. Maintaining and expanding this infrastructure is expensive and complex. Inefficiencies or operational failures, including temporary or permanent loss of customer data, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

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**We are subject to government litigation and regulatory activity that affects how we design and market our products.** As a leading global software maker, we receive close scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers to assert claims of anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints include limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. We believe we are in full compliance with these rules. However, if we fail to comply with them, additional restrictions could be imposed on us that would adversely affect our business.

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

Government regulatory actions and court decisions such as these may hinder our ability to provide the benefits of our software to consumers and businesses, thereby reducing the attractiveness of our products and the revenues that come from them. New actions could be initiated at any time, either by these or other governments or private claimants, including with respect to new versions of Windows or other Microsoft products. The outcome of such actions, or steps taken to avoid them, could adversely affect us in a variety of ways, including:

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

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

The rulings described above may be cited as a precedent in other competition law proceedings.

Our software and services online offerings are subject to government regulation of the Internet domestically and internationally in many areas, including user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear and sometimes may conflict. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop the alleged noncompliant activity.

**Our business depends on our ability to attract and retain talented employees.** Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our

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ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

**Delays in product development schedules may adversely affect our revenues.** The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Our increasing focus on cloud-based software plus services also presents new and complex development issues. Significant delays in new product or service releases or significant problems in creating new products or services could adversely affect our revenue.



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### PART II

#### Item 1A

**We make significant investments in new products and services that may not be profitable.** Our growth depends on our ability to innovate by offering new, and adding value to our existing, software and service offerings. We will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, Zune, Windows Live, the Windows Azure Services platform, and other cloud-based services offerings, and Xbox 360. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Our degree of success with Windows Phone, for example, will impact our ability to grow share of the smartphone operating system market. It will also be an important factor in supporting our strategy of delivering value to end users seamlessly over PC, phone, and TV device classes. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

**Adverse economic conditions may harm our business.** Unfavorable changes in economic conditions, including inflation, recession, or other changes in economic conditions, may result in lower information technology spending and adversely affect our revenue. If demand for PCs, servers, and other computing devices declines, or consumer or business spending for those products declines, our revenue will be adversely affected. Our product distribution system also relies on an extensive partner network. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, could result in sales channel disruption. Challenging economic conditions also may impair the ability of our customers to pay for products and services they have purchased. As a result, reserves for doubtful accounts and write-offs of accounts receivable may increase. We maintain an investment portfolio of various holdings, types, and maturities. These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that have affected global financial markets. If global credit and equity markets experience prolonged periods of decline, our investment portfolio may be adversely impacted and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely impact our financial results.

**We have claims and lawsuits against us that may result in adverse outcomes.** We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. Although management currently believes resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial statements, the litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. A material adverse impact on our financial statements also could occur for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

**We may have additional tax liabilities.** We are subject to income taxes in the United States and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made.

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

**Our vertically-integrated hardware and software products may experience quality or supply problems.** Our hardware products such as the Xbox 360 console are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We obtain some components of our hardware devices from sole suppliers. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Either

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component shortages or excess or obsolete inventory may increase our cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenues and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

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**PART II**

Item 1A

**If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings.** Under accounting principles generally accepted in the United States ( U.S. GAAP ), we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is tested for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

**We operate a global business that exposes us to additional risks.** We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region and difficulties in staffing and managing foreign operations may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

**Catastrophic events or geo-political conditions may disrupt our business.** A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations and our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers. The long-term effects of climate change on the global economy in general or the information technology industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services. New regulations may require us to find alternative compliant and cost-effective methods of distributing our products and services.

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Item 1A, 2

**Acquisitions and joint ventures may have an adverse effect on our business.** We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don't realize a satisfactory return on our investment, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management's attention from our other businesses. These events could harm our operating results or financial condition.

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

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

**(c) STOCK REPURCHASES**

		(d) Approximate Dollar Value of			
Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	Shares that May Yet be Purchased under the Plans or Programs	
			(in millions)		
July 1, 2010	July 31, 2010	28,792,419	\$ 24.73	28,792,419	\$ 22,966
August 1, 2010	August 31, 2010	85,098,132	\$ 24.56	85,098,132	\$ 20,876
September 1, 2010	September 30, 2010	48,984,901	\$ 24.45	48,984,901	\$ 19,678
		162,875,452		162,875,452	

During the first quarter of fiscal year 2011, we repurchased 162.9 million shares of Microsoft common stock for \$4.0 billion using cash resources. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of September 30, 2010, approximately \$19.7 billion remained of our \$40.0 billion repurchase program that we announced on September 22, 2008. The program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

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**PART II**

Item 6

**ITEM 6. EXHIBITS**

4.5	Form of Second Supplemental Indenture for 0.875% Notes due 2013, 1.625% Notes due 2015, 3.00% Notes due 2020, and 4.50% Notes due 2040, dated as of September 27, 2010, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee (Incorporated by reference to Current Report on Form 8-K dated September 27, 2010)
10.18	Form of Executive Officer Incentive Plan Stock Award Agreement under the Microsoft Corporation 2001 Stock Plan
12	Computation of Ratio of Earnings to Fixed Charges
15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase
101.DEF**	XBRL Taxonomy Extension Definition Linkbase
101.LAB**	XBRL Taxonomy Extension Label Linkbase
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase

\* *Furnished, not filed.*

\*\* *Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.*

**Items 3 and 5 are not applicable and have been omitted.**

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**SIGNATURE**

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

MICROSOFT CORPORATION

/s/ FRANK H. BROD

Frank H. Brod

Corporate Vice President, Finance and Administration;

Chief Accounting Officer (Duly Authorized Officer)

October 28, 2010