# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 10-Q

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

**For the Quarterly Period Ended March 31, 2018**

**OR**

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

**For the Transition Period From to**

**Commission File Number: 001-37845**

# MICROSOFT CORPORATION

**(Exact name of registrant as specified in its charter)**

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

**(425) 882-8080**
**(Registrant's telephone number, including area code)**

**None**
**(Former name, former address and former fiscal year, if changed since last report)**

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

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

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

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

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

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

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

| **Class** | **Outstanding as of April 20, 2018** |
|---|---|
| Common Stock, $0.00000625 par value per share | 7,683,197,503 shares |

**MICROSOFT CORPORATION**

**FORM 10-Q**

**For the Quarter Ended March 31, 2018**

**INDEX**


| | | Page |
|---|---|---|
| **PART I.** | **FINANCIAL INFORMATION** | |
| Item 1. | Financial Statements | |
| a) | Income Statements for the Three and Nine Months Ended March 31, 2018 and 2017 | 3 |
| b) | Comprehensive Income Statements for the Three and Nine Months Ended March 31, 2018 and 2017 | 4 |
| c) | Balance Sheets as of March 31, 2018 and June 30, 2017 | 5 |
| d) | Cash Flows Statements for the Three and Nine Months Ended March 31, 2018 and 2017 | 6 |
| e) | Stockholders' Equity Statements for the Three and Nine Months Ended March 31, 2018 and 2017 | 7 |
| f) | Notes to Financial Statements | 8 |
| g) | Report of Independent Registered Public Accounting Firm | 38 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 39 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 54 |
| Item 4. | Controls and Procedures | 55 |
| **PART II.** | **OTHER INFORMATION** | |
| Item 1. | Legal Proceedings | 56 |
| Item 1A. | Risk Factors | 56 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 66 |
| Item 5. | Other Information | 66 |
| Item 6. | Exhibits | 67 |
| **SIGNATURE** | | 68 |

# PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

### INCOME STATEMENTS

| (In millions, except per share amounts) (Unaudited) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Revenue: | | | | |
| Product | **$ 15,114** | $ 14,513 | **$ 47,338** | $ 47,754 |
| Service and other | **11,705** | 8,699 | **32,937** | 23,212 |
| Total revenue | **26,819** | 23,212 | **80,275** | 70,966 |
| Cost of revenue: | | | | |
| Product | **3,425** | 3,075 | **11,903** | 12,034 |
| Service and other | **5,844** | 4,985 | **16,708** | 13,771 |
| Total cost of revenue | **9,269** | 8,060 | **28,611** | 25,805 |
| Gross margin | **17,550** | 15,152 | **51,664** | 45,161 |
| Research and development | **3,715** | 3,355 | **10,793** | 9,523 |
| Sales and marketing | **4,335** | 3,872 | **12,709** | 11,169 |
| General and administrative | **1,208** | 1,202 | **3,483** | 3,126 |
| Operating income | **8,292** | 6,723 | **24,679** | 21,343 |
| Other income, net | **349** | 371 | **1,115** | 600 |
| Income before income taxes | **8,641** | 7,094 | **25,794** | 21,943 |
| Provision for income taxes | **1,217** | 1,608 | **18,096** | 4,523 |
| Net income | **$ 7,424** | $ 5,486 | **$ 7,698** | $ 17,420 |
| Earnings per share: | | | | |
| Basic | **$ 0.96** | $ 0.71 | **$ 1.00** | $ 2.25 |
| Diluted | **$ 0.95** | $ 0.70 | **$ 0.99** | $ 2.22 |
| Weighted average shares outstanding: | | | | |
| Basic | **7,698** | 7,725 | **7,706** | 7,756 |
| Diluted | **7,794** | 7,813 | **7,798** | 7,840 |
| Cash dividends declared per common share | **$ 0.42** | $ 0.39 | **$ 1.26** | $ 1.17 |

Refer to accompanying notes.

## COMPREHENSIVE INCOME STATEMENTS

| (In millions) (Unaudited) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Net income | **$ 7,424** | $ 5,486 | **$ 7,698** | $ 17,420 |
| Other comprehensive income (loss), net of tax: | | | | |
| Net change related to derivatives | **7** | (225) | **(106)** | 18 |
| Net change related to investments | **(1,016)** | 65 | **(2,182)** | (846) |
| Translation adjustments and other | **255** | 349 | **508** | (125) |
| Other comprehensive income (loss) | **(754)** | 189 | **(1,780)** | (953) |
| Comprehensive income | **$ 6,670** | $ 5,675 | **$ 5,918** | $ 16,467 |

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

# BALANCE SHEETS

**(In millions) (Unaudited)**

| | March 31, 2018 | June 30, 2017 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 9,221** | $ 7,663 |
| Short-term investments | **123,049** | 125,318 |
| Total cash, cash equivalents, and short-term investments | **132,270** | 132,981 |
| Accounts receivable, net of allowance for doubtful accounts of **$311** and $345 | **17,208** | 22,431 |
| Inventories | **2,084** | 2,181 |
| Other | **5,097** | 5,103 |
| Total current assets | **156,659** | 162,696 |
| Property and equipment, net of accumulated depreciation of **$28,377** and $24,179 | **27,929** | 23,734 |
| Operating lease right-of-use assets | **6,859** | 6,555 |
| Equity and other investments | **2,818** | 6,023 |
| Goodwill | **35,582** | 35,122 |
| Intangible assets, net | **8,544** | 10,106 |
| Other long-term assets | **7,106** | 6,076 |
| Total assets | **$ 245,497** | $ 250,312 |
| **Liabilities and stockholders' equity** | | |
| Current liabilities: | | |
| Accounts payable | **$ 7,623** | $ 7,390 |
| Short-term debt | **230** | 9,072 |
| Current portion of long-term debt | **3,447** | 1,049 |
| Accrued compensation | **5,149** | 5,819 |
| Short-term income taxes | **814** | 718 |
| Short-term unearned revenue | **21,370** | 24,013 |
| Other | **7,500** | 7,684 |
| Total current liabilities | **46,133** | 55,745 |
| Long-term debt | **73,480** | 76,073 |
| Long-term income taxes | **30,669** | 13,485 |
| Long-term unearned revenue | **2,585** | 2,643 |
| Deferred income taxes | **2,417** | 5,734 |
| Operating lease liabilities | **5,751** | 5,372 |
| Other long-term liabilities | **5,223** | 3,549 |
| Total liabilities | **166,258** | 162,601 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock and paid-in capital – shares authorized 24,000; outstanding **7,690** and 7,708 | **70,418** | 69,315 |
| Retained earnings | **9,974** | 17,769 |
| Accumulated other comprehensive income (loss) | **(1,153)** | 627 |
| Total stockholders' equity | **79,239** | 87,711 |
| Total liabilities and stockholders' equity | **$ 245,497** | $ 250,312 |

Refer to accompanying notes.

## CASH FLOWS STATEMENTS

| (In millions) (Unaudited) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| **Operations** | | | | |
| Net income | **$ 7,424** | $ 5,486 | **$ 7,698** | $ 17,420 |
| Adjustments to reconcile net income to net cash from operations: | | | | |
| Depreciation, amortization, and other | **2,710** | 2,453 | **7,745** | 6,435 |
| Stock-based compensation expense | **969** | 883 | **2,928** | 2,353 |
| Net recognized gains on investments and derivatives | **(438)** | (590) | **(1,645)** | (1,553) |
| Deferred income taxes | **(396)** | (284) | **(2,754)** | 261 |
| Changes in operating assets and liabilities: | | | | |
| Accounts receivable | **1,285** | 1,415 | **5,326** | 5,813 |
| Inventories | **(75)** | (16) | **107** | 249 |
| Other current assets | **(149)** | (31) | **(113)** | 304 |
| Other long-term assets | **(213)** | (387) | **(835)** | (680) |
| Accounts payable | **(393)** | (425) | **138** | (769) |
| Unearned revenue | **91** | (45) | **(2,780)** | (2,929) |
| Income taxes | **645** | 1,247 | **17,280** | 2,654 |
| Other current liabilities | **546** | 671 | **(975)** | (1,057) |
| Other long-term liabilities | **145** | 283 | **346** | 1 |
| Net cash from operations | **12,151** | 10,660 | **32,466** | 28,502 |
| **Financing** | | | | |
| Repayments of short-term debt, maturities of 90 days or less, net | **(7,373)** | (1,302) | **(7,324)** | (8,447) |
| Proceeds from issuance of debt | **0** | 547 | **7,183** | 42,593 |
| Repayments of debt | **(4,883)** | (211) | **(9,379)** | (4,554) |
| Common stock issued | **251** | 179 | **747** | 551 |
| Common stock repurchased | **(3,781)** | (2,062) | **(8,359)** | (10,023) |
| Common stock cash dividends paid | **(3,232)** | (3,012) | **(9,473)** | (8,836) |
| Other, net | **(640)** | (375) | **(946)** | (175) |
| Net cash from (used in) financing | **(19,658)** | (6,236) | **(27,551)** | 11,109 |
| **Investing** | | | | |
| Additions to property and equipment | **(2,934)** | (1,695) | **(7,652)** | (5,846) |
| Acquisition of companies, net of cash acquired, and purchases of intangible and other assets | **(248)** | (802) | **(454)** | (25,586) |
| Purchases of investments | **(26,885)** | (43,918) | **(105,000)** | (147,874) |
| Maturities of investments | **7,674** | 4,860 | **19,252** | 22,234 |
| Sales of investments | **26,256** | 36,444 | **90,553** | 117,754 |
| Securities lending payable | **(19)** | (1,080) | **(90)** | (94) |
| Net cash from (used in) investing | **3,844** | (6,191) | **(3,391)** | (39,412) |
| Effect of foreign exchange rates on cash and cash equivalents | **25** | 12 | **34** | 4 |
| Net change in cash and cash equivalents | **(3,638)** | (1,755) | **1,558** | 203 |
| Cash and cash equivalents, beginning of period | | | | |

| | | | | |
|---|---|---|---|---|
| | **12,859** | 8,468 | **7,663** | 6,510 |
| Cash and cash equivalents, end of period | **$ 9,221** | $ 6,713 | **$ 9,221** | $ 6,713 |

Refer to accompanying notes.

## STOCKHOLDERS' EQUITY STATEMENTS

| (In millions) (Unaudited) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| **Common stock and paid-in capital** | | | | |
| Balance, beginning of period | **$ 70,192** | $ 68,177 | **$ 69,315** | $ 68,178 |
| Common stock issued | **251** | 179 | **747** | 551 |
| Common stock repurchased | **(995)** | (684) | **(2,572)** | (2,619) |
| Stock-based compensation expense | **969** | 883 | **2,928** | 2,353 |
| Other, net | **1** | (1) | **0** | 91 |
| Balance, end of period | **70,418** | 68,554 | **70,418** | 68,554 |
| **Retained earnings** | | | | |
| Balance, beginning of period | **8,567** | 13,000 | **17,769** | 13,118 |
| Net income | **7,424** | 5,486 | **7,698** | 17,420 |
| Common stock cash dividends | **(3,225)** | (3,009) | **(9,696)** | (9,037) |
| Common stock repurchased | **(2,792)** | (1,381) | **(5,797)** | (7,405) |
| Balance, end of period | **9,974** | 14,096 | **9,974** | 14,096 |
| **Accumulated other comprehensive income (loss)** | | | | |
| Balance, beginning of period | **(399)** | 652 | **627** | 1,794 |
| Other comprehensive income (loss) | **(754)** | 189 | **(1,780)** | (953) |
| Balance, end of period | **(1,153)** | 841 | **(1,153)** | 841 |
| Total stockholders' equity | **$ 79,239** | $ 83,491 | **$ 79,239** | $ 83,491 |

Refer to accompanying notes.

# NOTES TO FINANCIAL STATEMENTS

***(Unaudited)***

## NOTE 1 — ACCOUNTING POLICIES

### Accounting Principles

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

We have recast certain prior period income tax liabilities as discussed in the Recent Tax Legislation section below. We have also recast prior period securities lending payables to other current liabilities on our consolidated balance sheets to conform to the current period presentation, with no impact on consolidated net income or cash flows.

### Principles of Consolidation

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

### Estimates and Assumptions

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

### Revenue

#### *Product Revenue and Service and Other Revenue*

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

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

***Revenue Recognition***

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

*Nature of Products and Services*

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

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

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

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

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

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

*Significant Judgments*

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

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

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

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

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

***Contract Balances***

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

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

As of March 31, 2018 and June 30, 2017, long-term accounts receivable, net of allowance for doubtful accounts, were $1.6 billion and $1.7 billion, respectively, and are included in other long-term assets on our consolidated balance sheets.

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

Activity in the allowance for doubtful accounts was as follows:

| **(In millions)** | | |
|---|---|---|
| **Nine Months Ended March 31, 2018** | | |
| Balance, beginning of period | **$** | **361** |
| Charged to costs and other | | **41** |
| Write-offs | | **(74)** |
| Balance, end of period | **$** | **328** |
| **Reported as of March 31, 2018** | | |
| Accounts receivable, net of allowance for doubtful accounts | **$** | **311** |
| Other long-term assets | | **17** |
| Total | **$** | **328** |

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

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

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

***Assets Recognized from Costs to Obtain a Contract with a Customer***

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

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

**Leases**

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

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

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

**Recent Tax Legislation**

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

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

| (In millions) | As Previously Reported | As Adjusted |
|---|---|---|
| **Balance Sheets** | | **June 30, 2017** |
| Long-term income taxes | $ 0 | $ 13,485 |
| Other long-term liabilities | 17,034 | 3,549 |

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

## Recent Accounting Guidance

### *Recently Adopted Accounting Guidance*

*Leases*

In February 2016, the Financial Accounting Standards Board ("FASB") issued a new standard related to leases to increase transparency and comparability among organizations by requiring the recognition of ROU assets and lease liabilities on the balance sheet. Most prominent among the changes in the standard is the recognition of ROU assets and lease liabilities by lessees for those leases classified as operating leases. Under the standard, disclosures are required to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We are also required to recognize and measure leases existing at, or entered into after, the beginning of the earliest comparative period presented using a modified retrospective approach, with certain practical expedients available.

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

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

*Revenue from Contracts with Customers*

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

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

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

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

*Impacts to Previously Reported Results*

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

| (In millions, except per share amounts) | As Previously Reported | New Revenue Standard Adjustment | As Restated |
|---|---|---|---|
| **Income Statements** | | | |
| **Three Months Ended March 31, 2017** | | | |
| Revenue | $ 22,090 | $ 1,122 | $ 23,212 |
| Provision for income taxes | 1,115 | 493 | 1,608 |
| Net income | 4,801 | 685 | 5,486 |
| Diluted earnings per share | 0.61 | 0.09 | 0.70 |
| **Nine Months Ended March 31, 2017** | | | |
| Revenue | $ 66,633 | $ 4,333 | $ 70,966 |
| Provision for income taxes | 2,913 | 1,610 | 4,523 |
| Net income | 14,691 | 2,729 | 17,420 |
| Diluted earnings per share | 1.87 | 0.35 | 2.22 |

| (In millions) | As Previously Reported | New Revenue Standard Adjustment | New Lease Standard Adjustment | As Restated |
|---|---|---|---|---|
| **Balance Sheets** | | | | |
| **June 30, 2017** | | | | |
| Accounts receivable, net of allowance for doubtful accounts | $ 19,792 | $ 2,639 | $ 0 | $ 22,431 |
| Operating lease right-of-use assets | 0 | 0 | 6,555 | 6,555 |
| Other current and long-term assets | 11,147 | 32 | 0 | 11,179 |
| Unearned revenue | 44,479 | (17,823) | 0 | 26,656 |
| Deferred income taxes | 531 | 5,203 | 0 | 5,734 |
| Operating lease liabilities | 0 | 0 | 5,372 | 5,372 |
| Other current and long-term liabilities | 23,464 | (26) | 1,183 | 24,621 |
| Stockholders' equity | 72,394 | 15,317 | 0 | 87,711 |

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

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

*Financial Instruments – Targeted Improvements to Accounting for Hedging Activities*

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

*Accounting for Income Taxes – Intra-Entity Asset Transfers*

In October 2016, the FASB issued new guidance requiring an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than when the asset has been sold to an outside party. This guidance is effective for us beginning July 1, 2018, with early adoption permitted beginning July 1, 2017. We plan to adopt the guidance effective July 1, 2018. Adoption of the guidance will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. A cumulative-effect adjustment will capture the write-off of income tax consequences deferred from past intra-entity transfers involving assets other than inventory and new deferred tax assets for amounts not recognized under current GAAP. As a result of the TCJA, we are currently reevaluating the impact of this standard on our consolidated financial statements, including accounting policies, processes, and systems.

*Financial Instruments – Credit Losses*

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

*Financial Instruments – Recognition, Measurement, Presentation, and Disclosure*

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

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

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

## NOTE 2 — EARNINGS PER SHARE

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

The components of basic and diluted EPS were as follows:

| (In millions, except per share amounts) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| Net income available for common shareholders (A) | **$ 7,424** | $ 5,486 | **$ 7,698** | $ 17,420 |
| Weighted average outstanding shares of common stock (B) | **7,698** | 7,725 | **7,706** | 7,756 |
| Dilutive effect of stock-based awards | **96** | 88 | **92** | 84 |
| Common stock and common stock equivalents (C) | **7,794** | 7,813 | **7,798** | 7,840 |
| **Earnings Per Share** | | | | |
| Basic (A/B) | **$ 0.96** | $ 0.71 | **$ 1.00** | $ 2.25 |
| Diluted (A/C) | **$ 0.95** | $ 0.70 | **$ 0.99** | $ 2.22 |

Anti-dilutive stock-based awards excluded from the calculations of diluted EPS were immaterial during the periods presented.

## NOTE 3 — OTHER INCOME (EXPENSE), NET

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

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| Dividends and interest income | **$ 575** | $ 380 | **$ 1,578** | $ 984 |
| Interest expense | **(691)** | (609) | **(2,061)** | (1,567) |
| Net recognized gains on investments | **510** | 790 | **1,851** | 1,893 |
| Net losses on derivatives | **(72)** | (200) | **(206)** | (340) |
| Net gains (losses) on foreign currency remeasurements | **20** | 50 | **(49)** | (143) |
| Other, net | **7** | (40) | **2** | (227) |
| Total | **$ 349** | $ 371 | **$ 1,115** | $ 600 |

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

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| Other-than-temporary impairments of investments | **$ (17)** | $ (15) | **$ (47)** | $ (54) |
| Realized gains from sales of available-for-sale securities | **875** | 938 | **2,612** | 2,272 |
| Realized losses from sales of available-for-sale securities | **(348)** | (133) | **(714)** | (325) |

| | | | | |
|---|---|---|---|---|
| Total | **$ 510** | $ 790 | **$ 1,851** | $ 1,893 |

## NOTE 4 — INVESTMENTS

### Investment Components

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

| (In millions) | Cost Basis | Unrealized Gains | Unrealized Losses | Recorded Basis | Cash and Cash Equivalents | Short-term Investments | Equity and Other Investments |
|---|---|---|---|---|---|---|---|
| **March 31, 2018** | | | | | | | |
| Cash | $ 4,104 | $ 0 | $ 0 | $ 4,104 | $ 4,104 | $ 0 | $ 0 |
| Mutual funds | 683 | 0 | 0 | 683 | 683 | 0 | 0 |
| Commercial paper | 3,774 | 0 | 0 | 3,774 | 3,158 | 616 | 0 |
| Certificates of deposit | 2,022 | 0 | 0 | 2,022 | 1,156 | 866 | 0 |
| U.S. government and agency securities | 108,056 | 31 | (1,239) | 106,848 | 117 | 106,731 | 0 |
| Foreign government bonds | 4,671 | 3 | (12) | 4,662 | 3 | 4,659 | 0 |
| Mortgage- and asset-backed securities | 3,750 | 5 | (12) | 3,743 | 0 | 3,743 | 0 |
| Corporate notes and bonds | 6,139 | 27 | (43) | 6,123 | 0 | 6,123 | 0 |
| Municipal securities | 269 | 41 | (1) | 309 | 0 | 309 | 0 |
| Common and preferred stock | 1,324 | 917 | (4) | 2,237 | 0 | 0 | 2,237 |
| Other investments | 583 | 0 | 0 | 583 | 0 | 2 | 581 |
| Total | $ 135,375 | $ 1,024 | $ (1,311) | $ 135,088 | $ 9,221 | $ 123,049 | $ 2,818 |

| (In millions) | Cost Basis | Unrealized Gains | Unrealized Losses | Recorded Basis | Cash and Cash Equivalents | Short-term Investments | Equity and Other Investments |
|---|---|---|---|---|---|---|---|
| **June 30, 2017** | | | | | | | |
| Cash | $ 3,624 | $ 0 | $ 0 | $ 3,624 | $ 3,624 | $ 0 | $ 0 |
| Mutual funds | 1,478 | 0 | 0 | 1,478 | 1,478 | 0 | 0 |
| Commercial paper | 319 | 0 | 0 | 319 | 69 | 250 | 0 |
| Certificates of deposit | 1,358 | 0 | 0 | 1,358 | 972 | 386 | 0 |
| U.S. government and agency securities | 112,119 | 85 | (360) | 111,844 | 16 | 111,828 | 0 |
| Foreign government bonds | 5,276 | 2 | (13) | 5,265 | 1,504 | 3,761 | 0 |
| Mortgage- and asset-backed securities | 3,921 | 14 | (4) | 3,931 | 0 | 3,931 | 0 |
| Corporate notes and bonds | 4,786 | 61 | (12) | 4,835 | 0 | 4,835 | 0 |
| Municipal securities | 284 | 43 | 0 | 327 | 0 | 327 | 0 |
| Common and preferred stock | 2,472 | 3,062 | (34) | 5,500 | 0 | 0 | 5,500 |
| Other investments | 523 | 0 | 0 | 523 | 0 | 0 | 523 |
| Total | $ 136,160 | $ 3,267 | $ (423) | $ 139,004 | $ 7,663 | $ 125,318 | $ 6,023 |

As of March 31, 2018 and June 30, 2017, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $1.0 billion and $1.1 billion, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

We lend certain fixed-income and equity securities to increase investment returns. These transactions are accounted for as secured borrowings and the loaned securities continue to be carried as investments on our consolidated balance sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. As of March 31, 2018 and June 30, 2017, collateral received under agreements for loaned securities was $3.0 billion and $3.7 billion, respectively, and primarily comprised U.S. government and agency securities.

**Unrealized Losses on Investments**

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

| | Less than 12 Months | | 12 Months or Greater | | | |
|---|---|---|---|---|---|---|
| **(In millions)** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** | **Total Fair Value** | **Total Unrealized Losses** |
| **March 31, 2018** | | | | | | |
| U.S. government and agency securities | **$ 95,908** | **$ (1,169)** | **$ 2,031** | **$ (70)** | **$ 97,939** | **$ (1,239)** |
| Foreign government bonds | **1,261** | **(3)** | **26** | **(9)** | **1,287** | **(12)** |
| Mortgage- and asset-backed securities | **1,614** | **(7)** | **147** | **(5)** | **1,761** | **(12)** |
| Corporate notes and bonds | **2,463** | **(30)** | **430** | **(13)** | **2,893** | **(43)** |
| Municipal securities | **36** | **(1)** | **0** | **0** | **36** | **(1)** |
| Common and preferred stock | **19** | **0** | **23** | **(4)** | **42** | **(4)** |
| Total | **$ 101,301** | **$ (1,210)** | **$ 2,657** | **$ (101)** | **$ 103,958** | **$ (1,311)** |

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

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

**Debt Investment Maturities**

| **(In millions)** | **Cost Basis** | **Estimated Fair Value** |
|---|---|---|
| **March 31, 2018** | | |
| Due in one year or less | $ 16,698 | $ 16,670 |
| Due after one year through five years | 94,607 | 93,722 |
| Due after five years through 10 years | 16,427 | 16,133 |
| Due after 10 years | 949 | 956 |
| Total | $ 128,681 | $ 127,481 |

## NOTE 5 — DERIVATIVES

We use derivative instruments to manage risks related to foreign currencies, equity prices, interest rates, and credit; to enhance investment returns; and to facilitate portfolio diversification. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the economic impact of these exposures as effectively as possible.

Our derivative programs include strategies that both qualify and do not qualify for hedge accounting treatment. All notional amounts presented below are measured in U.S. dollar equivalents.

### Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, Canadian dollar, and Australian dollar. As of March 31, 2018 and June 30, 2017, the total notional amounts of these foreign exchange contracts sold were $7.5 billion and $8.9 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of March 31, 2018 and June 30, 2017, the total notional amounts of these foreign exchange contracts sold were $4.5 billion and $5.1 billion, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures. As of March 31, 2018, the total notional amounts of these foreign exchange contracts purchased and sold were $9.1 billion and $9.7 billion, respectively. As of June 30, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were $8.8 billion and $10.6 billion, respectively.

### Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of March 31, 2018, the total notional amounts of equity contracts purchased and sold for managing market price risk were $801 million and $820 million, respectively, of which $731 million and $815 million, respectively, were designated as hedging instruments. As of June 30, 2017, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.9 billion and $2.4 billion, respectively, of which $1.6 billion and $1.8 billion, respectively, were designated as hedging instruments.

### 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 March 31, 2018, the total notional amounts of fixed-interest rate contracts purchased and sold were $620 million and $424 million, respectively. As of June 30, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were $233 million and $352 million, respectively.

In addition, we use “To Be Announced” forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of March 31, 2018 and June 30, 2017, the total notional derivative amounts of mortgage contracts purchased were $563 million and $567 million, respectively.

**Credit**

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low-cost method of managing exposure to individual credit risks or groups of credit risks. As of March 31, 2018, the total notional amounts of credit contracts purchased and sold were $238 million and $31 million, respectively. As of June 30, 2017, the total notional amounts of credit contracts purchased and sold were $267 million and $63 million, respectively.

**Credit-Risk-Related Contingent Features**

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of March 31, 2018, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral was required to be posted.

**Fair Values of Derivative Instruments**

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

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

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

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

The following table presents the fair values of derivative instruments designated as hedging instruments ("designated hedge derivatives") and not designated as hedging instruments ("non-designated hedge derivatives"). The fair values exclude the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

| | Assets | | | | Liabilities | |
|---|---|---|---|---|---|---|
| (In millions) | Short-term Investments | Other Current Assets | Equity and Other Investments | Other Long-term Assets | Other Current Liabilities | Other Long-term Liabilities |
| **March 31, 2018** | | | | | | |
| **Non-designated Hedge Derivatives** | | | | | | |
| Foreign exchange contracts | $ 3 | $ 67 | $ 0 | $ 59 | $ (142) | $ (9) |
| Equity contracts | 4 | 0 | 0 | 0 | (4) | 0 |
| Interest rate contracts | 15 | 0 | 0 | 0 | (2) | 0 |
| Credit contracts | 4 | 0 | 0 | 0 | 0 | 0 |
| Total | $ 26 | $ 67 | $ 0 | $ 59 | $ (148) | $ (9) |
| **Designated Hedge Derivatives** | | | | | | |
| Foreign exchange contracts | $ 10 | $ 71 | $ 0 | $ 6 | $ (70) | $ (6) |
| Equity contracts | 0 | 0 | 12 | 0 | (95) | 0 |
| Total | $ 10 | $ 71 | $ 12 | $ 6 | $ (165) | $ (6) |
| Total gross amounts of derivatives | $ 36 | $ 138 | $ 12 | $ 65 | $ (313) | $ (15) |
| Gross derivatives either offset or subject to an enforceable master netting agreement | $ 31 | $ 138 | $ 12 | $ 65 | $ (313) | $ (15) |
| Gross amounts of derivatives offset on the balance sheet | (34) | (102) | (12) | (9) | 150 | 9 |
| Net amounts presented on the balance sheet | (3) | 36 | 0 | 56 | (163) | (6) |
| Gross amounts of derivatives not offset on the balance sheet | 0 | 0 | 0 | 0 | 0 | 0 |
| Cash collateral received | 0 | 0 | 0 | 0 | (61) | 0 |
| Net amount | $ (3) | $ 36 | $ 0 | $ 56 | $ (224) | $ (6) |

| (In millions) | Assets: Short-term Investments | Assets: Other Current Assets | Assets: Equity and Other Investments | Assets: Other Long-term Assets | Liabilities: Other Current Liabilities | Liabilities: Other Long-term Liabilities |
|---|---|---|---|---|---|---|
| **June 30, 2017** | | | | | | |
| **Non-designated Hedge Derivatives** | | | | | | |
| Foreign exchange contracts | $ 9 | $ 203 | $ 0 | $ 6 | $ (134) | $ (8) |
| Equity contracts | 3 | 0 | 0 | 0 | (6) | 0 |
| Interest rate contracts | 3 | 0 | 0 | 0 | (7) | 0 |
| Credit contracts | 5 | 0 | 0 | 0 | (1) | 0 |
| Total | $ 20 | $ 203 | $ 0 | $ 6 | $ (148) | $ (8) |
| **Designated Hedge Derivatives** | | | | | | |
| Foreign exchange contracts | $ 80 | $ 133 | $ 0 | $ 0 | $ (3) | $ 0 |
| Equity contracts | 0 | 0 | 67 | 0 | (186) | 0 |
| Total | $ 80 | $ 133 | $ 67 | $ 0 | $ (189) | $ 0 |
| Total gross amounts of derivatives | $ 100 | $ 336 | $ 67 | $ 6 | $ (337) | $ (8) |
| Gross derivatives either offset or subject to an enforceable master netting agreement | $ 100 | $ 336 | $ 67 | $ 6 | $ (334) | $ (8) |
| Gross amounts of derivatives offset on the balance sheet | (20) | (132) | (67) | (8) | 221 | 7 |
| Net amounts presented on the balance sheet | 80 | 204 | 0 | (2) | (113) | (1) |
| Gross amounts of derivatives not offset on the balance sheet | 0 | 0 | 0 | 0 | 0 | 0 |
| Cash collateral received | 0 | 0 | 0 | 0 | (228) | 0 |
| Net amount | $ 80 | $ 204 | $ 0 | $ (2) | $ (341) | $ (1) |

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

**Fair Value Hedge Gains (Losses)**

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

| (In millions) | Three Months Ended March 31, 2018 | Three Months Ended March 31, 2017 | Nine Months Ended March 31, 2018 | Nine Months Ended March 31, 2017 |
|---|---|---|---|---|
| **Foreign Exchange Contracts** | | | | |
| Derivatives | **$ (260)** | $ (248) | **$ (224)** | $ 389 |
| Hedged items | **288** | 257 | **298** | (349) |
| Total amount of ineffectiveness | **$ 28** | $ 9 | **$ 74** | $ 40 |
| **Equity Contracts** | | | | |
| Derivatives | **$ 126** | $ (19) | **$ (181)** | $ (36) |
| Hedged items | **(126)** | 19 | **181** | 36 |
| Total amount of ineffectiveness | **$ 0** | $ 0 | **$ 0** | $ 0 |
| Amount of equity contracts excluded from effectiveness assessment | **$ 0** | $ (25) | **$ 60** | $ (29) |

## Cash Flow Hedge Gains (Losses)

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

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| **Effective Portion** | | | | |
| Gains (losses) recognized in other comprehensive income (loss) (net of tax of **$7,** $3**, $8,** and $7) | **$ 14** | $ (60) | **$ 29** | $ 424 |
| Gains reclassified from accumulated other comprehensive income (loss) into revenue | **8** | 167 | **138** | 414 |
| **Amount Excluded from Effectiveness Assessment and Ineffective Portion** | | | | |
| Losses recognized in other income (expense), net | **(62)** | (121) | **(226)** | (275) |

We estimate that $34 million of net derivative gains included in AOCI as of March 31, 2018 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during the three and nine months ended March 31, 2018.

## Non-designated Derivative Gains (Losses)

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense), net. These amounts are shown in the table below, with the exception of gains (losses) on derivatives presented in income statement line items other than other income (expense), net, which were immaterial for the periods presented. Other than those derivatives entered into for investment purposes, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities and gains (losses) from foreign exchange rate changes on certain balance sheet amounts.

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| Foreign exchange contracts | **$ (64)** | $ (115) | **$ (248)** | $ (120) |
| Equity contracts | **(11)** | (42) | **(89)** | (84) |
| Interest-rate contracts | **(18)** | 8 | **(9)** | 2 |
| Credit contracts | **0** | 1 | **0** | 5 |
| Other contracts | **0** | (18) | **0** | (18) |
| Total | **$ (93)** | $ (166) | **$ (346)** | $ (215) |

## NOTE 6 — FAIR VALUE MEASUREMENTS

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

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

- *Level 2* – inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, credit spreads, foreign exchange rates, and forward and spot prices for currencies. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, foreign government bonds, commercial paper, mortgage- and asset-backed securities, and certificates of deposit. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.
- *Level 3* – inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models. Our Level 3 non-derivative assets and liabilities primarily comprise investments in common and preferred stock, and goodwill and intangible assets, when they are recorded at fair value due to an impairment charge. Unobservable inputs used in the models are significant to the fair values of the assets and liabilities.

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

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

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

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

| (In millions) | Level 1 | Level 2 | Level 3 | Gross Fair Value | Netting[(a)] | Net Fair Value |
|---|---|---|---|---|---|---|
| **March 31, 2018** | | | | | | |
| **Assets** | | | | | | |
| Mutual funds | $ 683 | $ 0 | $ 0 | $ 683 | $ 0 | $ 683 |
| Commercial paper | 0 | 3,774 | 0 | 3,774 | 0 | 3,774 |
| Certificates of deposit | 0 | 2,022 | 0 | 2,022 | 0 | 2,022 |
| U.S. government and agency securities | 106,324 | 523 | 0 | 106,847 | 0 | 106,847 |
| Foreign government bonds | 20 | 4,699 | 0 | 4,719 | 0 | 4,719 |
| Mortgage- and asset-backed securities | 0 | 3,738 | 0 | 3,738 | 0 | 3,738 |
| Corporate notes and bonds | 0 | 6,067 | 7 | 6,074 | 0 | 6,074 |
| Municipal securities | 0 | 309 | 0 | 309 | 0 | 309 |
| Common and preferred stock | 1,188 | 0 | 18 | 1,206 | 0 | 1,206 |
| Derivatives | 4 | 246 | 1 | 251 | (157) | 94 |
| Total | $ 108,219 | $ 21,378 | $ 26 | $ 129,623 | $ (157) | $ 129,466 |
| **Liabilities** | | | | | | |
| Derivatives and other | $ 1 | $ 327 | $ 0 | $ 328 | $ (159) | $ 169 |

| (In millions) | Level 1 | Level 2 | Level 3 | Gross Fair Value | Netting[(a)] | Net Fair Value |
|---|---|---|---|---|---|---|
| **June 30, 2017** | | | | | | |
| **Assets** | | | | | | |
| Mutual funds | $ 1,478 | $ 0 | $ 0 | $ 1,478 | $ 0 | $ 1,478 |
| Commercial paper | 0 | 319 | 0 | 319 | 0 | 319 |
| Certificates of deposit | 0 | 1,358 | 0 | 1,358 | 0 | 1,358 |
| U.S. government and agency securities | 109,228 | 2,616 | 0 | 111,844 | 0 | 111,844 |
| Foreign government bonds | 0 | 5,187 | 0 | 5,187 | 0 | 5,187 |
| Mortgage- and asset-backed securities | 0 | 3,934 | 0 | 3,934 | 0 | 3,934 |
| Corporate notes and bonds | 0 | 4,829 | 1 | 4,830 | 0 | 4,830 |
| Municipal securities | 0 | 327 | 0 | 327 | 0 | 327 |
| Common and preferred stock | 2,414 | 1,994 | 18 | 4,426 | 0 | 4,426 |
| Derivatives | 1 | 508 | 0 | 509 | (227) | 282 |
| Total | $ 113,121 | $ 21,072 | $ 19 | $ 134,212 | $ (227) | $ 133,985 |
| **Liabilities** | | | | | | |
| Derivatives and other | $ 0 | $ 345 | $ 39 | $ 384 | $ (228) | $ 156 |

(a) *These amounts represent the impact of netting derivative assets and derivative liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk.*

The changes in our Level 3 financial instruments that are measured at fair value on a recurring basis were immaterial during the periods presented.

The following table reconciles the total “Net Fair Value” of assets above to the balance sheet presentation of these same assets in Note 4 – Investments.

| (In millions) | March 31, 2018 | June 30, 2017 |
|---|---|---|
| Net fair value of assets measured at fair value on a recurring basis | **$ 129,466** | $ 133,985 |
| Cash | **4,104** | 3,624 |
| Common and preferred stock measured at fair value on a nonrecurring basis | **1,030** | 1,073 |
| Other investments measured at fair value on a nonrecurring basis | **581** | 523 |
| Less derivative net assets classified as other current and long-term assets | **(92)** | (202) |
| Other | **(1)** | 1 |
| Recorded basis of investment components | **$ 135,088** | $ 139,004 |

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

During the three and nine months ended March 31, 2018 and 2017, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

## NOTE 7 — INVENTORIES

The components of inventories were as follows:

| (In millions) | March 31, 2018 | June 30, 2017 |
|---|---|---|
| Raw materials | **$ 627** | $ 797 |
| Work in process | **67** | 145 |
| Finished goods | **1,390** | 1,239 |
| Total | **$ 2,084** | $ 2,181 |

## NOTE 8 — BUSINESS COMBINATIONS

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

## NOTE 9 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

| (In millions) | June 30, 2017 | Acquisitions | Other | March 31, 2018 |
|---|---|---|---|---|
| Productivity and Business Processes | **$ 23,739** | **$ 0** | **$ 85** | **$ 23,824** |
| Intelligent Cloud | **5,555** | **164** | **4** | **5,723** |
| More Personal Computing | **5,828** | **111** | **96** | **6,035** |
| Total | **$ 35,122** | **$ 275** | **$ 185** | **$ 35,582** |

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

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

## NOTE 10 — INTANGIBLE ASSETS

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

| (In millions) | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|---|---|---|---|---|---|---|
| | | | March 31, 2018 | | | June 30, 2017 |
| Technology-based (a) | **$ 7,183** | **$ (4,690)** | **$ 2,493** | $ 7,765 | $ (4,318) | $ 3,447 |
| Customer-related | **4,035** | **(1,073)** | **2,962** | 4,045 | (692) | 3,353 |
| Marketing-related | **4,031** | **(1,025)** | **3,006** | 4,016 | (829) | 3,187 |
| Contract-based | **667** | **(584)** | **83** | 841 | (722) | 119 |
| Total | **$ 15,916** | **$ (7,372)** | **$ 8,544** | $ 16,667 | $ (6,561) | $ 10,106 |

(a) *Technology-based intangible assets included $19 million and $59 million of net carrying amount of software to be sold, leased, or otherwise marketed as of March 31, 2018 and June 30, 2017, respectively.*

Intangible assets amortization expense was $560 million and $1.7 billion for the three and nine months ended March 31, 2018, respectively, and $560 million and $1.1 billion for the three and nine months ended March 31, 2017, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held as of March 31, 2018:

| **(In millions)** | |
|---|---|
| **Year Ending June 30,** | |
| 2018 (excluding the nine months ended March 31, 2018) | $ 562 |
| 2019 | 1,717 |
| 2020 | 1,210 |
| 2021 | 1,020 |
| 2022 | 941 |
| Thereafter | 3,094 |
| Total | $ 8,544 |

## NOTE 11 — DEBT

### Short-term Debt

As of March 31, 2018, we had $231 million of commercial paper issued and outstanding, with a weighted average interest rate of 1.43% and maturities ranging from 139 days to 196 days. As of June 30, 2017, we had $9.1 billion of commercial paper issued and outstanding, with a weighted average interest rate of 1.01% and maturities ranging from 25 days to 264 days. The estimated fair value of this commercial paper approximates its carrying value.

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

### Long-term Debt

As of March 31, 2018, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $76.9 billion and $78.9 billion, respectively. As of June 30, 2017, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $77.1 billion and $80.3 billion, respectively. These estimated fair values are based on Level 2 inputs.

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

| (In millions, except interest rates) | Face Value March 31, 2018 | Face Value June 30, 2017 | Stated Interest Rate | Effective Interest Rate |
|---|---|---|---|---|
| **Notes** | | | | |
| November 15, 2017 | **$ 0** | $ 600 | **0.875%** | **1.084%** |
| May 1, 2018 | **450** | 450 | **1.000%** | **1.106%** |
| November 3, 2018 | **1,750** | 1,750 | **1.300%** | **1.396%** |
| December 6, 2018 | **1,250** | 1,250 | **1.625%** | **1.824%** |
| June 1, 2019 | **1,000** | 1,000 | **4.200%** | **4.379%** |
| August 8, 2019 | **2,500** | 2,500 | **1.100%** | **1.203%** |
| November 1, 2019 | **18** | 18 | **0.500%** | **0.500%** |
| February 6, 2020 | **1,500** | 1,500 | **1.850%** | **1.952%** |
| February 12, 2020 | **1,500** | 1,500 | **1.850%** | **1.935%** |
| October 1, 2020 | **1,000** | 1,000 | **3.000%** | **3.137%** |
| November 3, 2020 | **2,250** | 2,250 | **2.000%** | **2.093%** |
| February 8, 2021 | **500** | 500 | **4.000%** | **4.082%** |
| August 8, 2021 | **2,750** | 2,750 | **1.550%** | **1.642%** |
| December 6, 2021 (a) | **2,153** | 1,996 | **2.125%** | **2.233%** |
| February 6, 2022 | **1,750** | 1,750 | **2.400%** | **2.520%** |
| February 12, 2022 | **1,500** | 1,500 | **2.375%** | **2.466%** |
| November 3, 2022 | **1,000** | 1,000 | **2.650%** | **2.717%** |
| November 15, 2022 | **750** | 750 | **2.125%** | **2.239%** |
| May 1, 2023 | **1,000** | 1,000 | **2.375%** | **2.465%** |
| August 8, 2023 | **1,500** | 1,500 | **2.000%** | **2.101%** |
| December 15, 2023 | **1,500** | 1,500 | **3.625%** | **3.726%** |
| February 6, 2024 | **2,250** | 2,250 | **2.875%** | **3.041%** |
| February 12, 2025 | **2,250** | 2,250 | **2.700%** | **2.772%** |
| November 3, 2025 | **3,000** | 3,000 | **3.125%** | **3.176%** |
| August 8, 2026 | **4,000** | 4,000 | **2.400%** | **2.464%** |
| February 6, 2027 | **4,000** | 4,000 | **3.300%** | **3.383%** |
| December 6, 2028 (a) | **2,153** | 1,996 | **3.125%** | **3.218%** |
| May 2, 2033 (a) | **676** | 627 | **2.625%** | **2.690%** |
| February 12, 2035 | **1,500** | 1,500 | **3.500%** | **3.604%** |
| November 3, 2035 | **1,000** | 1,000 | **4.200%** | **4.260%** |
| August 8, 2036 | **2,250** | 2,250 | **3.450%** | **3.510%** |
| February 6, 2037 | **2,500** | 2,500 | **4.100%** | **4.152%** |
| June 1, 2039 | **750** | 750 | **5.200%** | **5.240%** |
| October 1, 2040 | **1,000** | 1,000 | **4.500%** | **4.567%** |
| February 8, 2041 | **1,000** | 1,000 | **5.300%** | **5.361%** |
| November 15, 2042 | **900** | 900 | **3.500%** | **3.571%** |
| May 1, 2043 | **500** | 500 | **3.750%** | **3.829%** |
| December 15, 2043 | **500** | 500 | **4.875%** | **4.918%** |
| February 12, 2045 | **1,750** | 1,750 | **3.750%** | **3.800%** |
| November 3, 2045 | **3,000** | 3,000 | **4.450%** | **4.492%** |
| August 8, 2046 | **4,500** | 4,500 | **3.700%** | **3.743%** |
| February 6, 2047 | **3,000** | 3,000 | **4.250%** | **4.287%** |
| February 12, 2055 | **2,250** | 2,250 | **4.000%** | **4.063%** |
| November 3, 2055 | **1,000** | 1,000 | **4.750%** | **4.782%** |
| August 8, 2056 | **2,250** | 2,250 | **3.950%** | **4.033%** |
| February 6, 2057 | **2,000** | 2,000 | **4.500%** | **4.528%** |
| Total | **$ 77,600** | $ 77,837 | | |

(a) *Euro-denominated debt securities.*

The notes in the table above are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. As of March 31, 2018 and June 30, 2017, the aggregate debt issuance costs and unamortized discount associated with our long-term debt, including the current portion, were $673 million and $715 million, respectively.

## NOTE 12 — INCOME TAXES

Income tax expense includes U.S. and international income taxes, and interest and penalties on uncertain tax positions. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. Deferred tax assets are reported net of a valuation allowance when it is more likely than not that a tax benefit will not be realized. All deferred income taxes are classified as long-term on our consolidated balance sheets.

**Effective Tax Rate**

Our effective tax rate was 14% and 23% for the three months ended March 31, 2018 and 2017, respectively, and 70% and 21% for the nine months ended March 31, 2018 and 2017, respectively. The decrease in our effective tax rate for the current quarter compared to the prior year was primarily due to the reduction of the U.S. federal statutory tax rate as a result of the TCJA. The increase in our effective tax rate for the year-to-date compared to the prior year was primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018.

Our effective tax rate for the three months ended March 31, 2018 was lower than the U.S. federal statutory rate, primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico. Our effective tax rate for the nine months ended March 31, 2018 was higher than the U.S. federal statutory rate, primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018.

**Recent Tax Legislation**

On December 22, 2017, the TCJA was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business, such as imposing a one-time transition tax on deemed repatriation of deferred foreign income, reducing the U.S. federal statutory tax rate, and adopting a territorial tax system. The TCJA required us to incur a one-time transition tax on deferred foreign income not previously subject to U.S. income tax at a rate of 15.5% for foreign cash and certain other net current assets, and 8% on the remaining income. The TCJA also reduced the U.S. federal statutory tax rate from 35% to 21% effective January 1, 2018. For fiscal year 2018, our blended U.S. federal statutory tax rate is 28%. This is the result of using the tax rate of 35% for the first and second quarter of fiscal year 2018 and the reduced tax rate of 21% for the third and fourth quarter of fiscal year 2018. The TCJA includes a provision to tax global intangible low-taxed income (“GILTI”) of foreign subsidiaries and a base erosion anti-abuse tax (“BEAT”) measure that taxes certain payments between a U.S. corporation and its subsidiaries. The GILTI and BEAT provisions of the TCJA will be effective for us beginning July 1, 2018.

The TCJA was effective in the second quarter of fiscal year 2018. As of March 31, 2018, we have not completed our accounting for the tax effects of the TCJA. During the second quarter of fiscal year 2018, we recorded a provisional net charge based on reasonable estimates for those tax effects. We have not recorded any adjustments to our provisional net charge in the third quarter of fiscal year 2018. Due to the timing of the enactment and the complexity in applying the provisions of the TCJA, the provisional net charge is subject to revisions as we continue to complete our analysis of the TCJA, collect and prepare necessary data, and interpret any additional guidance issued by the U.S. Treasury Department, Internal Revenue Service (“IRS”), FASB, and other standard-setting and regulatory bodies. Adjustments may materially impact our provision for income taxes and effective tax rate in the period in which the adjustments are made. Our accounting for the tax effects of the TCJA will be completed during the measurement period, which should not extend beyond one year from the enactment date. The impacts of our estimates are described further below.

During the second quarter of fiscal year 2018, we recorded an estimated net charge of $13.8 billion related to the TCJA, due to the impact of the one-time transition tax on the deemed repatriation of deferred foreign income of $17.8 billion, offset in part by the impact of changes in the tax rate of $4.0 billion, primarily on deferred tax assets and liabilities.

We recorded an estimated $17.8 billion charge in the second quarter of fiscal year 2018 related to the transition tax, which was included in provision for income taxes on our consolidated income statements and income taxes on our consolidated balance sheets. We have not yet completed our accounting for the transition tax as our analysis of deferred foreign income is not complete. To calculate the transition tax, we estimated our deferred foreign income for fiscal year 2017 and for the first and second quarter of fiscal year 2018 because these tax returns are not complete or due. The fiscal year 2017 and fiscal year 2018 taxable income will be known once the respective tax returns are completed and filed. In addition, U.S. and foreign audit settlements may significantly impact the estimated transition tax. The impact of the U.S. and foreign audits on the transition tax will be known as the audits are concluded.

In addition, we recorded an estimated $4.0 billion benefit in the second quarter of fiscal year 2018 from the impact of changes in the tax rate, primarily on deferred tax assets and liabilities, which was included in provision for income taxes on our consolidated income statements and deferred income taxes on our consolidated balance sheets. We remeasured our deferred taxes to reflect the reduced rate that will apply when these deferred taxes are settled or realized in future periods. We have not yet completed our accounting for the measurement of deferred taxes. To calculate the remeasurement of deferred taxes, we estimated when the existing deferred taxes will be settled or realized. The remeasurement of deferred taxes included in our financial statements will be subject to further revisions if our current estimates are different from our actual future operating results.

The TCJA subjects a U.S. corporation to tax on its GILTI. Due to the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the TCJA and the application of GAAP. Under GAAP, we can make an accounting policy election to either treat taxes due on the GILTI inclusion as a current period expense, or factor such amounts into our measurement of deferred taxes. We elected the deferred method and recorded an estimated $454 million benefit in the second quarter of fiscal year 2018 related to GILTI, which is included in the net charge related to the TCJA.

**Uncertain Tax Positions**

While we settled a portion of the IRS audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. In the second quarter of fiscal year 2018, we settled a portion of the IRS audit for tax years 2010 to 2013. We continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of March 31, 2018, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2017, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

Tax contingencies and other income tax liabilities were $14.5 billion and $13.5 billion as of March 31, 2018 and June 30, 2017, respectively, and are included in long-term income taxes on our consolidated balance sheets. This increase relates primarily to current period intercompany transfer pricing.

## NOTE 13 — RESTRUCTURING CHARGES

In June 2017, management approved a sales and marketing restructuring plan. In fiscal year 2017, we recorded employee severance expenses of $306 million primarily related to this sales and marketing restructuring plan. We do not expect to incur additional charges for this restructuring plan in subsequent years. The actions associated with this restructuring plan are expected to be completed by the end of fiscal year 2018.

Changes in the restructuring liability were as follows:

| (In millions) | Severance | Other[a] | Total |
|---|---|---|---|
| **Nine Months Ended March 31, 2018** | | | |
| Balance, beginning of period | **$ 373** | **$ 59** | **$ 432** |
| Restructuring charges | **0** | **0** | **0** |
| Cash paid | **(373)** | **(24)** | **(397)** |
| Other | **0** | **(7)** | **(7)** |
| Balance, end of period | **$ 0** | **$ 28** | **$ 28** |

(a) *Primarily reflects activities associated with the consolidation of our phone facilities, manufacturing operations, and contract termination costs.*

## NOTE 14 — UNEARNED REVENUE

Unearned revenue by segment was as follows:

| (In millions) | March 31, 2018 | June 30, 2017 |
|---|---|---|
| Productivity and Business Processes | **$ 11,185** | $ 12,692 |
| Intelligent Cloud | **9,987** | 11,152 |
| More Personal Computing | **2,783** | 2,812 |
| Total | **$ 23,955** | $ 26,656 |

The opening balance of unearned revenue was $22.2 billion as of July 1, 2016.

Changes in unearned revenue were as follows:

| (In millions) | |
|---|---|
| **Nine Months Ended March 31, 2018** | |
| Balance, beginning of period | **$ 26,656** |
| Deferral of revenue | **37,217** |
| Recognition of unearned revenue | **(39,918)** |
| Balance, end of period | **$ 23,955** |

Revenue allocated to remaining performance obligations represents contracted revenue that has not yet been recognized ("contracted not recognized revenue"), which includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. Contracted not recognized revenue was $61 billion as of March 31, 2018, of which we expect to recognize approximately 60% of the revenue over the next 12 months and the remainder thereafter.

## NOTE 15 — LEASES

We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which include options to extend the leases for up to 5 years, and some of which include options to terminate the leases within 1 year.

The components of lease expense were as follows:

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Operating lease cost | $ 395 | $ 321 | $ 1,182 | $ 1,015 |
| Finance lease cost: | | | | |
| Amortization of right-of-use assets | $ 70 | $ 29 | $ 175 | $ 67 |
| Interest on lease liabilities | 47 | 19 | 121 | 46 |
| Total finance lease cost | $ 117 | $ 48 | $ 296 | $ 113 |

Supplemental cash flow information related to leases was as follows:

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Cash paid for amounts included in the measurement of lease liabilities: | | | | |
| Operating cash flows from operating leases | $ 388 | $ 331 | $ 1,132 | $ 912 |
| Operating cash flows from finance leases | 46 | 19 | 121 | 46 |
| Financing cash flows from finance leases | 37 | 14 | 93 | 29 |
| Right-of-use assets obtained in exchange for lease obligations: | | | | |
| Operating leases | 570 | 130 | 1,269 | 304 |
| Finance leases | 412 | 296 | 1,790 | 1,061 |

Supplemental balance sheet information related to leases was as follows:

| (In millions, except lease term and discount rate) | March 31, 2018 | June 30, 2017 |
|---|---|---|
| **Operating Leases** | | |
| Operating lease right-of-use assets | $ 6,859 | $ 6,555 |
| Other current liabilities | $ 1,382 | $ 1,423 |
| Operating lease liabilities | 5,751 | 5,372 |
| Total operating lease liabilities | $ 7,133 | $ 6,795 |
| **Finance Leases** | | |
| Property and equipment, gross | $ 4,507 | $ 2,658 |
| Accumulated depreciation | (336) | (161) |
| Property and equipment, net | $ 4,171 | $ 2,497 |
| Other current liabilities | $ 181 | $ 113 |
| Other long-term liabilities | 4,150 | 2,425 |
| Total finance lease liabilities | $ 4,331 | $ 2,538 |
| **Weighted Average Remaining Lease Term** | | |
| Operating leases | 7 years | 7 years |
| Finance leases | 14 years | 13 years |
| **Weighted Average Discount Rate** | | |
| Operating leases | 2.6% | 2.5% |
| Finance leases | 5.3% | 4.7% |

Maturities of lease liabilities were as follows:

**(In millions)**

| Year Ending June 30, | Operating Leases | Finance Leases |
|---|---|---|
| 2018 (excluding the nine months ended March 31, 2018) | $ 388 | $ 104 |
| 2019 | 1,472 | 384 |
| 2020 | 1,340 | 391 |
| 2021 | 1,076 | 399 |
| 2022 | 887 | 406 |
| Thereafter | 2,790 | 4,442 |
| Total lease payments | 7,953 | 6,126 |
| Less imputed interest | (820) | (1,795) |
| Total | $ 7,133 | $ 4,331 |

As of March 31, 2018, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $845 million and $1.5 billion, respectively. These operating and finance leases will commence between fiscal year 2018 and fiscal year 2020 with lease terms of 1 year to 20 years.

## NOTE 16 — CONTINGENCIES

### Patent and Intellectual Property Claims

#### *IPCom Patent Litigation*

IPCom GmbH & Co. (“IPCom”) is a German company that holds a large portfolio of mobile technology-related patents addressing a broad range of cellular technologies. IPCom has asserted 19 of these patents in litigation against Nokia Corporation (“Nokia”) and many of the leading cellular phone companies and operators. In April 2018, Microsoft and IPCom entered into a settlement agreement resolving all claims against us.

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

In addition to the IPCom cases, there were 34 other patent infringement cases pending against Microsoft as of March 31, 2018.

### Antitrust, Unfair Competition, and Overcharge Class Actions

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

The trial of the British Columbia action commenced in May 2016. The plaintiffs filed their case in chief in August 2016, setting out claims made, authorities, and evidence in support of their claims. A six-month oral hearing is expected to begin in summer 2018, consisting of cross examination on witness affidavits. The Ontario and Quebec cases are inactive.

### Other Antitrust Litigation and Claims

#### *China State Administration for Industry and Commerce Investigation*

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

**Product-Related Litigation**

***U.S. Cell Phone Litigation***

Microsoft Mobile Oy, a subsidiary of Microsoft, along with other handset manufacturers and network operators, is a defendant in 35 lawsuits filed in the Superior Court for the District of Columbia by individual plaintiffs who allege that radio emissions from cellular handsets caused their brain tumors and other adverse health effects. We assumed responsibility for these claims in our agreement to acquire Nokia's Devices and Services business and have been substituted for the Nokia defendants. Nine of these cases were filed in 2002 and are consolidated for certain pre-trial proceedings; the remaining cases are stayed. In a separate 2009 decision, the Court of Appeals for the District of Columbia held that adverse health effect claims arising from the use of cellular handsets that operate within the U.S. Federal Communications Commission radio frequency emission guidelines ("FCC Guidelines") are pre-empted by federal law. The plaintiffs allege that their handsets either operated outside the FCC Guidelines or were manufactured before the FCC Guidelines went into effect. The lawsuits also allege an industry-wide conspiracy to manipulate the science and testing around emission guidelines.

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

***Canadian Cell Phone Class Action***

Microsoft Mobile Oy, along with other handset manufacturers and network operators, is a defendant in a 2013 class action lawsuit filed in the Supreme Court of British Columbia by a purported class of Canadians who have used cellular phones for at least 1,600 hours, including a subclass of users with brain tumors, alleging adverse health effects from cellular phone use. Microsoft was served with the complaint in June 2014 and has been substituted for the Nokia defendants. The litigation has been dormant for more than three years.

**Employment-Related Litigation**

***Moussouris v. Microsoft***

Current and former female Microsoft employees in certain engineering and information technology roles brought this class action in federal court in Seattle in 2015, alleging systemic gender discrimination in pay and promotions. The plaintiffs moved to certify the class in October 2017. Microsoft filed an opposition in January 2018, attaching an expert report showing no statistically significant disparity in pay and promotions between similarly situated men and women. Microsoft filed a motion for summary judgment with respect to the named plaintiffs in March 2018.

**Other Contingencies**

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

As of March 31, 2018, we accrued aggregate legal liabilities of $371 million. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $1.3 billion in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our consolidated financial statements for the period in which the effects become reasonably estimable.

## NOTE 17 — STOCKHOLDERS' EQUITY

### Share Repurchases

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

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing up to an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of March 31, 2018, $30.3 billion remained of this $40.0 billion share repurchase program.

We repurchased the following shares of common stock under the share repurchase programs:

| (In millions) | Shares | Amount | Shares | Amount |
|---|---|---|---|---|
| **Fiscal Year** | | **2018** | | **2017** |
| First Quarter | **22** | **$ 1,600** | 63 | $ 3,550 |
| Second Quarter | **22** | **1,800** | 59 | 3,533 |
| Third Quarter | **34** | **3,100** | 25 | 1,600 |
| Total | **78** | **$ 6,500** | 147 | $ 8,683 |

Shares repurchased beginning in the third quarter of fiscal year 2017 were under the share repurchase program approved September 20, 2016. Shares repurchased during the first and second quarter of fiscal year 2017 were under the share repurchase program approved September 16, 2013. The above table excludes shares repurchased to settle employee tax withholding related to the vesting of stock awards. All repurchases were made using cash resources.

### Dividends

Our Board of Directors declared the following dividends:

| Declaration Date | Dividend Per Share | Record Date | Amount | Payment Date |
|---|---|---|---|---|
| **Fiscal Year 2018** | | | **(in millions)** | |
| **September 19, 2017** | **$ 0.42** | **November 16, 2017** | **$ 3,238** | **December 14, 2017** |
| **November 29, 2017** | **0.42** | **February 15, 2018** | **3,232** | **March 8, 2018** |
| **March 12, 2018** | **0.42** | **May 17, 2018** | **3,230** | **June 14, 2018** |
| **Fiscal Year 2017** | | | | |
| September 20, 2016 | $ 0.39 | November 17, 2016 | $ 3,024 | December 8, 2016 |
| November 30, 2016 | 0.39 | February 16, 2017 | 3,012 | March 9, 2017 |
| March 14, 2017 | 0.39 | May 18, 2017 | 3,009 | June 8, 2017 |

The dividend declared on March 12, 2018 was included in other current liabilities as of March 31, 2018.

## NOTE 18 — ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| **Derivatives** | | | | |
| Balance, beginning of period | **$ 21** | $ 595 | **$ 134** | $ 352 |
| Unrealized gains (losses), net of tax of **$7**, $3, **$8**, and $7 | **15** | (60) | **30** | 424 |
| Reclassification adjustments for gains included in revenue | **(8)** | (167) | **(138)** | (414) |
| Tax expense included in provision for income taxes | **0** | 2 | **2** | 8 |
| Amounts reclassified from accumulated other comprehensive income | **(8)** | (165) | **(136)** | (406) |
| Net change related to derivatives, net of tax of **$7**, $1**, $6**, and $(1) | **7** | (225) | **(106)** | 18 |
| Balance, end of period | **$ 28** | $ 370 | **$ 28** | $ 370 |
| **Investments** | | | | |
| Balance, beginning of period | **$ 659** | $ 2,030 | **$ 1,825** | $ 2,941 |
| Unrealized gains (losses), net of tax of **$(186)**, $307, **$(347)**, and $197 | **(644)** | 571 | **(961)** | 367 |
| Reclassification adjustments for gains included in other income (expense), net | **(517)** | (779) | **(1,823)** | (1,867) |
| Tax expense included in provision for income taxes | **145** | 273 | **602** | 654 |
| Amounts reclassified from accumulated other comprehensive income | **(372)** | (506) | **(1,221)** | (1,213) |
| Net change related to investments, net of tax of **$(331)**, $34, **$(949)**, and $(457) | **(1,016)** | 65 | **(2,182)** | (846) |
| Balance, end of period | **$ (357)** | $ 2,095 | **$ (357)** | $ 2,095 |
| **Translation Adjustments and Other** | | | | |
| Balance, beginning of period | **$ (1,079)** | $ (1,973) | **$ (1,332)** | $ (1,499) |
| Translation adjustments and other, net of tax of **$0**, $0, **$(1)**, and $7 | **255** | 349 | **508** | (125) |
| Balance, end of period | **$ (824)** | $ (1,624) | **$ (824)** | $ (1,624) |
| Accumulated other comprehensive income (loss), end of period | **$ (1,153)** | $ 841 | **$ (1,153)** | $ 841 |

## NOTE 19 — SEGMENT INFORMATION AND GEOGRAPHIC DATA

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

Our reportable segments are described below.

**Productivity and Business Processes**

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

- Office Commercial, including Office 365 subscriptions and Office licensed on-premises, comprising Office, Exchange, SharePoint, Skype for Business, and Microsoft Teams, and related Client Access Licenses ("CALs").
- Office Consumer, including Office 365 subscriptions and Office licensed on-premises, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.
- LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.
- Dynamics business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.

**Intelligent Cloud**

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

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

**More Personal Computing**

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

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

Revenue and costs are generally directly attributed to our segments. However, due to the integrated structure of our business, certain revenue recognized and costs incurred by one segment may benefit other segments. Revenue from certain contracts is allocated among the segments based on the relative value of the underlying products and services, which can include allocation based on actual prices charged, prices when sold separately, or estimated costs plus a profit margin. Cost of revenue is allocated in certain cases based on a relative revenue methodology. Operating expenses that are allocated primarily include those relating to marketing of products and services from which multiple segments benefit, and are generally allocated based on relative gross margin.

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

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

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| **Revenue** | | | | |
| Productivity and Business Processes | **$ 9,006** | $ 7,707 | **$ 26,197** | $ 21,322 |
| Intelligent Cloud | **7,896** | 6,730 | **22,613** | 19,585 |
| More Personal Computing | **9,917** | 8,775 | **31,465** | 30,059 |
| Total | **$ 26,819** | $ 23,212 | **$ 80,275** | $ 70,966 |
| **Operating Income** | | | | |
| Productivity and Business Processes | **$ 3,115** | $ 2,540 | **$ 9,458** | $ 8,498 |
| Intelligent Cloud | **2,654** | 2,148 | **7,623** | 6,216 |
| More Personal Computing | **2,523** | 2,035 | **7,598** | 6,629 |
| Total | **$ 8,292** | $ 6,723 | **$ 24,679** | $ 21,343 |

No sales to an individual customer or country other than the United States accounted for more than 10% of revenue for the three or nine months ended March 31, 2018 or 2017. Revenue, classified by the major geographic areas in which our customers are located, was as follows:

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| United States (a) | **$ 13,457** | $ 12,298 | **$ 41,094** | $ 37,628 |
| Other countries | **13,362** | 10,914 | **39,181** | 33,338 |
| Total | **$ 26,819** | $ 23,212 | **$ 80,275** | $ 70,966 |

(a) *Includes billings to original equipment manufacturers and certain multinational organizations because of the nature of these businesses and the impracticability of determining the geographic source of the revenue.*

Revenue from external customers, classified by significant product and service offerings, was as follows:

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Office products and cloud services | **$ 7,088** | $ 6,234 | **$ 20,739** | $ 18,655 |
| Server products and cloud services | **6,343** | 5,297 | **18,139** | 15,319 |
| Windows | **4,612** | 4,253 | **14,094** | 13,701 |
| Gaming | **2,251** | 1,906 | **8,067** | 7,409 |
| Search advertising | **1,784** | 1,599 | **5,243** | 4,633 |
| Enterprise Services | **1,489** | 1,383 | **4,295** | 4,109 |
| Devices | **1,219** | 958 | **3,851** | 4,017 |
| LinkedIn | **1,335** | 976 | **3,795** | 1,204 |
| Other | **698** | 606 | **2,052** | 1,919 |
| Total | **$ 26,819** | $ 23,212 | **$ 80,275** | $ 70,966 |

Our commercial cloud revenue, which primarily comprises Office 365 commercial, Azure, Dynamics 365, and other cloud properties, was $6.0 billion and $16.3 billion for the three and nine months ended March 31, 2018, respectively, and $3.8 billion and $10.4 billion for the three and nine months ended March 31, 2017, respectively. These amounts are primarily included in Office products and cloud services and server products and cloud services in the table above.

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; it is impracticable for us to separately identify the amount

of amortization and depreciation by segment that is included in the measure of segment profit or loss.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation
Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the "Company") as of March 31, 2018, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the three-month and nine-month periods ended March 31, 2018 and 2017. These interim financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of June 30, 2017, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the year then ended prior to retrospective adjustment for the changes in the Company's method of accounting for revenue from contracts with customers and for leases, (not presented herein); and in our report dated August 2, 2017, we expressed an unqualified opinion on those consolidated financial statements. We also audited the adjustments described in Note 1 that were applied to retrospectively adjust the June 30, 2017 consolidated balance sheet of Microsoft Corporation and subsidiaries. In our opinion, such adjustments are appropriate and have been properly applied to the previously issued consolidated balance sheet in deriving the accompanying retrospectively adjusted consolidated balance sheet as of June 30, 2017.

/S/ DELOITTE & TOUCHE LLP

Seattle, Washington
April 26, 2018

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

## Note About Forward-Looking Statements

This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors" (Part II, Item 1A of this Form 10-Q). These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "future," "opportunity," "plan," "may," "should," "will," "would," "will be," "will continue," "will likely result," and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Quantitative and Qualitative Disclosures about Market Risk" (Part I, Item 3 of this Form 10-Q), and "Risk Factors" (Part II, Item 1A of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our Annual Report on Form 10-K for the year ended June 30, 2017, and our financial statements and the accompanying Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

## OVERVIEW

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our strategy is to build best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence ("AI"). We develop, license, and support a wide range of software products, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people's lives. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

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

Highlights from the third quarter of fiscal year 2018 compared with the third quarter of fiscal year 2017 included:

- Commercial cloud revenue, which primarily comprises Microsoft Office 365 commercial, Microsoft Azure, Microsoft Dynamics 365, and other cloud properties, increased 58% to $6.0 billion.
- Office Commercial revenue increased 14%, driven by Office 365 commercial revenue growth of 42%.
- Office Consumer revenue increased 12% and Office 365 consumer subscribers increased to 30.6 million.
- LinkedIn revenue increased 37%, driven by strong momentum across all business lines.
- Dynamics revenue increased 17%, driven by Dynamics 365 revenue growth of 65%.
- Server products and cloud services revenue increased 20%, driven by Azure revenue growth of 93%.
- Enterprise Services revenue increased 8%.
- Windows original equipment manufacturer licensing ("Windows OEM") revenue increased 4%, driven by OEM Pro revenue growth of 11%.
- Windows Commercial revenue increased 21%, driven by an increased volume of multi-year agreements and the mix of products that carry higher in-quarter revenue recognition.

- Gaming revenue increased 18%, driven by Xbox software and services revenue growth of 24%, mainly from third-party title strength.
- Microsoft Surface revenue increased 32% against a prior year comparable impacted by product end-of-life-cycle dynamics.
- Search advertising revenue, excluding traffic acquisition costs, increased 16%, driven by higher revenue per search and search volume.

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business. During the second quarter of fiscal year 2018, we recorded a net charge of $13.8 billion related to the TCJA. Refer to Note 12 – Income Taxes of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

We adopted the new accounting standards for revenue recognition and leases effective July 1, 2017. These new standards had a material impact on our consolidated financial statements. Beginning in fiscal year 2018, our financial results reflect adoption of the standards with prior periods restated accordingly. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

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

**Industry Trends**

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

**Economic Conditions, Challenges, and Risks**

The markets for software, devices, and cloud-based services are dynamic and highly competitive. Our competitors are developing new software and devices, while also deploying competing cloud-based services for consumers and businesses. The devices and form factors customers prefer evolve rapidly, and influence how users access services in the cloud, and in some cases, the user's choice of which suite of cloud-based services to use. We must continue to evolve and adapt over an extended time in pace with this changing environment. The investments we are making in infrastructure and devices will continue to increase our operating costs and may decrease our operating margins.

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

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. Strengthening of the U.S. dollar relative to certain foreign currencies throughout fiscal year 2017 negatively impacted reported revenue and reduced reported expenses from our international operations. This trend has reversed in fiscal year 2018. Strengthening of foreign currencies relative to the U.S. dollar positively impacted reported revenue and increased reported expenses from our international operations.

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

## Seasonality

We expect our revenue to fluctuate quarterly and to be higher in the second and fourth quarters of our fiscal year. Second quarter revenue is driven by corporate year-end spending trends in our major markets and holiday season spending by consumers, and fourth quarter revenue is driven by the volume of multi-year on-premises contracts executed during the period.

## Reportable Segments

We report our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. The segment amounts included in MD&A are presented on a basis consistent with our internal management reporting. All differences between our internal management reporting basis and accounting principles generally accepted in the United States ("GAAP"), along with certain corporate-level and other activity, are included in Corporate and Other. We have recast certain previously reported amounts to conform to the way we internally manage and monitor segment performance.

Additional information on our reportable segments is contained in Note 19 – Segment Information and Geographic Data of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

### SUMMARY RESULTS OF OPERATIONS

| (In millions, except percentages and per share amounts) | Three Months Ended March 31, | | Percentage Change | Nine Months Ended March 31, | | Percentage Change |
|---|---|---|---|---|---|---|
| | 2018 | 2017 | | 2018 | 2017 | |
| Revenue | **$ 26,819** | $ 23,212 | 16% | **$ 80,275** | $ 70,966 | 13% |
| Gross margin | **17,550** | 15,152 | 16% | **51,664** | 45,161 | 14% |
| Operating income | **8,292** | 6,723 | 23% | **24,679** | 21,343 | 16% |
| Net income | **7,424** | 5,486 | 35% | **7,698** | 17,420 | (56)% |
| Diluted earnings per share | **0.95** | 0.70 | 36% | **0.99** | 2.22 | (55)% |
| Adjusted net income | **7,424** | 5,486 | 35% | **21,498** | 17,420 | 23% |
| Adjusted diluted earnings per share | **0.95** | 0.70 | 36% | **2.76** | 2.22 | 24% |

Consolidated results of operations include LinkedIn results since the date of acquisition on December 8, 2016. The nine months ended March 31, 2018 includes a full period of LinkedIn results, whereas the nine months ended March 31, 2017 only includes 113 days of LinkedIn results.

Adjusted net income and adjusted diluted earnings per share exclude the net charge related to the TCJA. Refer to the Non-GAAP Financial Measures section below for a reconciliation of our financial results reported in accordance with GAAP to non-GAAP financial results.

### *Three Months Ended March 31, 2018 Compared with Three Months Ended March 31, 2017*

Revenue increased $3.6 billion or 16%, driven by growth across each of our segments. Productivity and Business Processes revenue increased, driven by higher revenue from Office and LinkedIn. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue increased, driven by higher revenue from Windows, Gaming, Surface, and Search advertising. Revenue included a favorable foreign currency impact of 3%.

Gross margin increased $2.4 billion or 16%, due to growth across each of our segments. Gross margin included a favorable foreign currency impact of 3%. Gross margin percentage increased slightly, driven by gross margin percentage improvement in Productivity and Business Processes and favorable segment sales mix, offset in part by gross margin percentage decline in Intelligent Cloud. Gross margin included a 6-percentage point improvement in commercial cloud gross margin percentage, primarily across Azure and Office 365, offset in part by increased Azure sales mix.

Operating income increased $1.6 billion or 23%, driven by growth across each of our segments. Operating income included a favorable foreign currency impact of 3%.

Key changes in expenses were:

- Cost of revenue increased $1.2 billion or 15%, mainly due to growth in our commercial cloud and Gaming.
- Sales and marketing expenses increased $463 million or 12%, primarily due to investments in commercial sales capacity and LinkedIn. Sales and marketing included an unfavorable foreign currency impact of 3%.
- Research and development expenses increased $360 million or 11%, primarily due to investments in cloud engineering and LinkedIn.

***Nine Months Ended March 31, 2018 Compared with Nine Months Ended March 31, 2017***

Revenue increased $9.3 billion or 13%, driven by growth across each of our segments. Productivity and Business Processes revenue increased, driven by LinkedIn and higher revenue from Office. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue increased, driven by higher revenue from Gaming, Search advertising, Windows, and Surface, offset in part by lower revenue from Phones.

Gross margin increased $6.5 billion or 14%, due to growth across each of our segments. Gross margin percentage increased slightly, driven by gross margin percentage improvement in More Personal Computing and favorable segment sales mix, offset in part by gross margin percentage decline in Intelligent Cloud. Gross margin included a 7-percentage point improvement in commercial cloud gross margin percentage, primarily across Azure and Office 365, offset in part by increased Azure sales mix.

Operating income increased $3.3 billion or 16%, driven by growth across each of our segments. LinkedIn operating loss increased $234 million to $805 million, including $1.1 billion of amortization of intangible assets.

Key changes in expenses were:

- Cost of revenue increased $2.8 billion or 11%, mainly due to growth in our commercial cloud, LinkedIn, Gaming, and Search advertising, offset in part by a reduction in Phone cost of revenue.
- Sales and marketing expenses increased $1.5 billion or 14%, primarily due to LinkedIn expenses and investments in commercial sales capacity, offset in part by a decrease in Windows marketing expenses. Sales and marketing included an unfavorable foreign currency impact of 2%.
- Research and development expenses increased $1.3 billion or 13%, primarily due to LinkedIn expenses and investments in cloud engineering.
- General and administrative expenses increased $357 million or 11%, primarily due to LinkedIn expenses and the benefit of a legal settlement in the prior year.

Current year net income and diluted earnings per share were negatively impacted by the net charge related to TCJA, which resulted in a decrease to net income and diluted earnings per share of $13.8 billion and $1.77, respectively.

SEGMENT RESULTS OF OPERATIONS

| (In millions, except percentages) | Three Months Ended March 31, | | Percentage Change | Nine Months Ended March 31, | | Percentage Change |
|---|---|---|---|---|---|---|
| | 2018 | 2017 | | 2018 | 2017 | |
| **Revenue** | | | | | | |
| Productivity and Business Processes | **$ 9,006** | $ 7,707 | 17% | **$ 26,197** | $ 21,322 | 23% |
| Intelligent Cloud | **7,896** | 6,730 | 17% | **22,613** | 19,585 | 15% |
| More Personal Computing | **9,917** | 8,775 | 13% | **31,465** | 30,059 | 5% |
| Total | **$ 26,819** | $ 23,212 | 16% | **$ 80,275** | $ 70,966 | 13% |
| **Operating Income** | | | | | | |
| Productivity and Business Processes | **$ 3,115** | $ 2,540 | 23% | **$ 9,458** | $ 8,498 | 11% |
| Intelligent Cloud | **2,654** | 2,148 | 24% | **7,623** | 6,216 | 23% |
| More Personal Computing | **2,523** | 2,035 | 24% | **7,598** | 6,629 | 15% |
| Total | **$ 8,292** | $ 6,723 | 23% | **$ 24,679** | $ 21,343 | 16% |

## Reportable Segments

***Three Months Ended March 31, 2018 Compared with Three Months Ended March 31, 2017***

*Productivity and Business Processes*

Revenue increased $1.3 billion or 17%, including a favorable foreign currency impact of 3%.

- Office Commercial revenue increased $754 million or 14%, driven by Office 365 commercial revenue growth, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.
- Office Consumer revenue increased $108 million or 12%, driven by Office 365 consumer revenue growth, mainly due to growth in subscribers.
- LinkedIn revenue increased $359 million or 37%, driven by strong momentum across all businesses.
- Dynamics revenue increased 17%, driven by Dynamics 365 revenue growth.

Operating income increased $575 million or 23%, including a favorable foreign currency impact of 4%.

- Gross margin increased $1.0 billion or 18%, driven by growth in Office and LinkedIn. Gross margin percentage increased slightly, primarily due to gross margin percentage improvement in Office 365 commercial and LinkedIn, offset in part by an increased mix of cloud offerings. Gross margin included a favorable foreign currency impact of 3%.
- Operating expenses increased $468 million or 14%, driven by investments in LinkedIn, commercial sales capacity, and cloud engineering. Operating expenses included an unfavorable foreign currency impact of 2%.

*Intelligent Cloud*

Revenue increased $1.2 billion or 17%, including a favorable foreign currency impact of 2%.

- Server products and cloud services revenue increased $1.0 billion or 20%, driven by Azure revenue growth of 93% and server products licensed on-premises revenue growth of 3%.
- Enterprise Services revenue increased $106 million or 8%, driven by higher revenue from Premier Support Services and Microsoft Consulting Services, offset in part by a decline in revenue from custom support agreements.

Operating income increased $506 million or 24%, including a favorable foreign currency impact of 3%.

- Gross margin increased $739 million or 16%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies. Gross margin percentage decreased, primarily due to an increased mix of cloud offerings, offset in part by gross margin percentage improvement in Azure. Gross margin included a favorable foreign currency impact of 2%.
- Operating expenses increased $233 million or 9%, driven by investments in commercial sales capacity and cloud engineering. Operating expenses included an unfavorable foreign currency impact of 2%.

*More Personal Computing*

Revenue increased $1.1 billion or 13%.

- Windows revenue increased $359 million or 8%, driven by Windows Commercial and Windows OEM revenue growth. Windows Commercial revenue increased 21%, driven by an increased volume of multi-year agreements and the mix of products that carry higher in-quarter revenue recognition. Windows OEM revenue increased 4%. Windows OEM Pro revenue grew 11%, in line with a strengthening commercial PC market. Windows OEM non-Pro revenue declined 8%, below the consumer PC market, driven by a higher mix of lower priced licenses and continued pressure in the entry-level price category.
- Gaming revenue increased $345 million or 18%, driven by Xbox software and services revenue growth of 24%, mainly from third-party title strength.
- Surface revenue increased $263 million or 32% against a prior year comparable impacted by product end-of-life-cycle dynamics.
- Search advertising revenue increased $185 million or 12%. Search advertising revenue, excluding traffic acquisition costs, increased 16%, driven by growth in Bing, primarily due to higher revenue per search and search volume.

Operating income increased $488 million or 24%, including a favorable foreign currency impact of 4%.

- Gross margin increased $616 million or 13%, driven by growth in Windows and Surface. Gross margin percentage was relatively unchanged. Gross margin included a favorable foreign currency impact of 2%.
- Operating expenses increased $128 million or 5%, driven by investments in Gaming, Search advertising, and AI engineering.

***Nine Months Ended March 31, 2018 Compared with Nine Months Ended March 31, 2017***

*Productivity and Business Processes*

Revenue increased $4.9 billion or 23%.

- LinkedIn revenue increased $2.6 billion to $3.8 billion. LinkedIn revenue primarily consisted of revenue from Talent Solutions.
- Office Commercial revenue increased $1.8 billion or 12%, driven by Office 365 commercial revenue growth, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.
- Office Consumer revenue increased $307 million or 12%, driven by Office 365 consumer revenue growth, mainly due to growth in subscribers.
- Dynamics revenue increased 14%, driven by Dynamics 365 revenue growth.

Operating income increased $960 million or 11%.

- Gross margin increased $3.6 billion or 22%, driven by LinkedIn and growth in Office. Gross margin percentage decreased, due to an increased mix of cloud offerings and LinkedIn, offset in part by gross margin percentage improvement in Office 365 commercial. LinkedIn cost of revenue increased $768 million to $1.3 billion, including $664 million of amortization for acquired intangible assets.
- Operating expenses increased $2.6 billion or 34%, driven by LinkedIn expenses and investments in commercial sales capacity and cloud engineering. LinkedIn operating expenses increased $2.1 billion to $3.3 billion, including $463 million of amortization of acquired intangible assets.

*Intelligent Cloud*

Revenue increased $3.0 billion or 15%.

- Server products and cloud services revenue increased $2.8 billion or 18%, driven by Azure revenue growth of 94% and server products licensed on-premises revenue growth of 3%.
- Enterprise Services revenue increased $186 million or 5%, driven by higher revenue from Premier Support Services and Microsoft Consulting Services, offset in part by a decline in revenue from custom support agreements.

Operating income increased $1.4 billion or 23%.

- Gross margin increased $1.8 billion or 13%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies. Gross margin percentage decreased, due to an increased mix of cloud offerings, offset in part by gross margin percentage improvement in Azure.
- Operating expenses increased $391 million or 5%, driven by investments in commercial sales capacity and cloud engineering.

*More Personal Computing*

Revenue increased $1.4 billion or 5%.

- Windows revenue increased $393 million or 3%, driven by growth in Windows OEM and Windows Commercial, offset by a decline in patent licensing revenue. Windows OEM revenue increased 4%. Windows OEM Pro revenue grew 10%, slightly ahead of a strengthening commercial PC market. Windows OEM non-Pro revenue declined 4%, below the consumer PC market, driven by a higher mix of lower priced licenses and continued pressure in the entry-level price category. Windows Commercial revenue increased 8%, driven by multi-year agreement revenue growth.
- Gaming revenue increased $658 million or 9%, driven by Xbox software and services revenue growth of 15%, mainly from third-party title strength.
- Search advertising revenue increased $610 million or 13%. Search advertising revenue, excluding traffic acquisition costs, increased 15%, driven by growth in Bing, due to higher revenue per search and search volume.
- Surface revenue increased $389 million or 13% against a prior year comparable impacted by product end-of-life-cycle dynamics.
- Phone revenue decreased $524 million.

Operating income increased $969 million or 15%.

- Gross margin increased $1.1 billion or 7%, driven by growth in Windows, Surface, and Search advertising. Gross margin percentage increased, due to gross margin percentage improvement in Surface and a favorable sales mix.
- Operating expenses increased $139 million or 2%, driven by investments in Search advertising, AI, and Gaming engineering, offset in part by a decrease in Windows marketing expenses and Phone expenses.

## OPERATING EXPENSES

### Research and Development

| (In millions, except percentages) | Three Months Ended March 31, | | Percentage Change | Nine Months Ended March 31, | | Percentage Change |
|---|---|---|---|---|---|---|
| | 2018 | 2017 | | 2018 | 2017 | |
| Research and development | **$ 3,715** | $ 3,355 | 11% | **$ 10,793** | $ 9,523 | 13% |
| As a percent of revenue | **14%** | 14% | 0ppt | **13%** | 13% | 0ppt |

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.

***Three Months Ended March 31, 2018 Compared with Three Months Ended March 31, 2017***

Research and development expenses increased $360 million or 11%, primarily due to investments in cloud engineering and LinkedIn.

***Nine Months Ended March 31, 2018 Compared with Nine Months Ended March 31, 2017***

Research and development expenses increased $1.3 billion or 13%, primarily due to LinkedIn expenses and investments in cloud engineering. LinkedIn expenses increased $697 million to $1.1 billion.

**Sales and Marketing**

| (In millions, except percentages) | Three Months Ended March 31, | | Percentage Change | Nine Months Ended March 31, | | Percentage Change |
|---|---|---|---|---|---|---|
| | 2018 | 2017 | | 2018 | 2017 | |
| Sales and marketing | **$ 4,335** | $ 3,872 | 12% | **$ 12,709** | $ 11,169 | 14% |
| As a percent of revenue | **16%** | 17% | (1)ppt | **16%** | 16% | 0ppt |

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

***Three Months Ended March 31, 2018 Compared with Three Months Ended March 31, 2017***

Sales and marketing expenses increased $463 million or 12%, primarily due to investments in commercial sales capacity and LinkedIn. Sales and marketing included an unfavorable foreign currency impact of 3%.

***Nine Months Ended March 31, 2018 Compared with Nine Months Ended March 31, 2017***

Sales and marketing expenses increased $1.5 billion or 14%, primarily due to LinkedIn expenses and investments in commercial sales capacity, offset in part by a decrease in Windows marketing expenses. LinkedIn expenses increased $1.1 billion to $1.8 billion, including $463 million of amortization of acquired intangible assets. Sales and marketing included an unfavorable foreign currency impact of 2%.

**General and Administrative**

| (In millions, except percentages) | Three Months Ended March 31, | | Percentage Change | Nine Months Ended March 31, | | Percentage Change |
|---|---|---|---|---|---|---|
| | 2018 | 2017 | | 2018 | 2017 | |
| General and administrative | **$ 1,208** | $ 1,202 | 0% | **$ 3,483** | $ 3,126 | 11% |
| As a percent of revenue | **5%** | 5% | 0ppt | **4%** | 4% | 0ppt |

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

***Three Months Ended March 31, 2018 Compared with Three Months Ended March 31, 2017***

General and administrative expenses increased slightly.

***Nine Months Ended March 31, 2018 Compared with Nine Months Ended March 31, 2017***

General and administrative expenses increased $357 million or 11%, primarily due to LinkedIn expenses and the benefit of a legal settlement in the prior year. LinkedIn expenses increased $233 million to $393 million.

## OTHER INCOME (EXPENSE), NET

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

| (In millions) | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| Dividends and interest income | **$ 575** | $ 380 | **$ 1,578** | $ 984 |
| Interest expense | **(691)** | (609) | **(2,061)** | (1,567) |
| Net recognized gains on investments | **510** | 790 | **1,851** | 1,893 |
| Net losses on derivatives | **(72)** | (200) | **(206)** | (340) |
| Net gains (losses) on foreign currency remeasurements | **20** | 50 | **(49)** | (143) |
| Other, net | **7** | (40) | **2** | (227) |
| Total | **$ 349** | $ 371 | **$ 1,115** | $ 600 |

We use derivative instruments to: manage risks related to foreign currencies, equity prices, interest rates, and credit; enhance investment returns; and facilitate portfolio diversification. Gains and losses from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense), net. Other than those derivatives entered into for investment purposes, the gains (losses) are generally economically offset by unrealized (losses) gains in the underlying available-for-sale securities and (losses) gains on certain balance sheet amounts from foreign exchange rate changes.

***Three Months Ended March 31, 2018 Compared with Three Months Ended March 31, 2017***

Dividends and interest income increased primarily due to higher portfolio balances and yields on fixed-income securities. Interest expense increased primarily due to higher outstanding long-term debt and higher finance lease expense. Net recognized gains on investments decreased primarily due to higher losses on sales of fixed-income securities. Net losses on derivatives decreased primarily due to lower losses on foreign currency, equity, and other derivatives.

***Nine Months Ended March 31, 2018 Compared with Nine Months Ended March 31, 2017***

Dividends and interest income increased primarily due to higher portfolio balances and yields on fixed-income securities. Interest expense increased primarily due to higher outstanding long-term debt. Net recognized gains on investments decreased primarily due to higher losses on sales of fixed-income securities, offset in part by higher gains on equity securities. Net losses on derivatives decreased primarily due to lower losses on equity, foreign currency, and other derivatives. Other, net reflects recognized losses from certain joint ventures and divestitures in the prior period.

## INCOME TAXES

**Effective Tax Rate**

Our effective tax rate was 14% and 23% for the three months ended March 31, 2018 and 2017, respectively, and 70% and 21% for the nine months ended March 31, 2018 and 2017, respectively. The decrease in our effective tax rate for the current quarter compared to the prior year was primarily due to the reduction of the U.S. federal statutory tax rate as a result of the TCJA. The increase in our effective tax rate for the year-to-date compared to the prior year was primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018.

Our effective tax rate for the three months ended March 31, 2018 was lower than the U.S. federal statutory rate, primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico. Our effective tax rate for the nine months ended March 31, 2018 was higher than the U.S. federal statutory rate, primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018.

**Recent Tax Legislation**

On December 22, 2017, the TCJA was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business, such as imposing a one-time transition tax on deemed repatriation of deferred foreign income, reducing the U.S. federal statutory tax rate, and adopting a territorial tax system. The TCJA required us to incur a one-time transition tax on deferred foreign income not previously subject to U.S. income tax at a rate of 15.5% for foreign cash and certain other net current assets, and 8% on the remaining income. The TCJA also reduced the U.S. federal statutory tax rate from 35% to 21% effective January 1, 2018. For fiscal year 2018, our blended U.S. federal statutory tax rate is 28%. This is the result of using the tax rate of 35% for the first and second quarter of fiscal year 2018 and the reduced tax rate of 21% for the third and fourth quarter of fiscal year 2018. The TCJA includes a provision to tax global intangible low-taxed income ("GILTI") of foreign subsidiaries and a base erosion anti-abuse tax ("BEAT") measure that taxes certain payments between a U.S. corporation and its subsidiaries. The GILTI and BEAT provisions of the TCJA will be effective for us beginning July 1, 2018.

The TCJA was effective in the second quarter of fiscal year 2018. As of March 31, 2018, we have not completed our accounting for the tax effects of the TCJA. During the second quarter of fiscal year 2018, we recorded a provisional net charge based on reasonable estimates for those tax effects. We have not recorded any adjustments to our provisional net charge in the third quarter of fiscal year 2018. Due to the timing of the enactment and the complexity in applying the provisions of the TCJA, the provisional net charge is subject to revisions as we continue to complete our analysis of the TCJA, collect and prepare necessary data, and interpret any additional guidance issued by the U.S. Treasury Department, Internal Revenue Service ("IRS"), FASB, and other standard-setting and regulatory bodies. Adjustments may materially impact our provision for income taxes and effective tax rate in the period in which the adjustments are made. Our accounting for the tax effects of the TCJA will be completed during the measurement period, which should not extend beyond one year from the enactment date.

During the second quarter of fiscal year 2018, we recorded an estimated net charge of $13.8 billion related to the TCJA, due to the impact of the one-time transition tax on the deemed repatriation of deferred foreign income of $17.8 billion, offset in part by the impact of changes in the tax rate of $4.0 billion, primarily on deferred tax assets and liabilities.

**Uncertain Tax Positions**

While we settled a portion of the IRS audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. In the second quarter of fiscal year 2018, we settled a portion of the IRS audit for tax years 2010 to 2013. We continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of March 31, 2018, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2017, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

Tax contingencies and other income tax liabilities were $14.5 billion and $13.5 billion as of March 31, 2018 and June 30, 2017, respectively, and are included in long-term income taxes on our consolidated balance sheets. This increase relates primarily to current period intercompany transfer pricing.

## NON-GAAP FINANCIAL MEASURES

Adjusted net income and diluted earnings per share are non-GAAP financial measures which exclude the net charge related to the TCJA. We believe these non-GAAP measures aid investors by providing additional insight into our operational performance and help clarify trends affecting our business. For comparability of reporting, management considers non-GAAP measures in conjunction with GAAP financial results in evaluating business performance. These non-GAAP financial measures presented should not be considered a substitute for, or superior to, the measures of financial performance prepared in accordance with GAAP.

The following table reconciles our financial results reported in accordance with GAAP to non-GAAP financial results:

| (In millions, except percentages and per share amounts) | Three Months Ended March 31, | | Percentage Change | Nine Months Ended March 31, | | Percentage Change |
|---|---|---|---|---|---|---|
| | **2018** | **2017** | | **2018** | **2017** | |
| Net income | **$ 7,424** | $ 5,486 | 35% | **$ 7,698** | $ 17,420 | (56)% |
| Net charge related to the TCJA | **0** | 0 | | **13,800** | 0 | |
| Adjusted net income | **$ 7,424** | $ 5,486 | 35% | **$ 21,498** | $ 17,420 | 23% |
| Diluted earnings per share | **$ 0.95** | $ 0.70 | 36% | **$ 0.99** | $ 2.22 | (55)% |
| Net charge related to the TCJA | **0** | 0 | | **1.77** | 0 | |
| Adjusted diluted earnings per share | **$ 0.95** | $ 0.70 | 36% | **$ 2.76** | $ 2.22 | 24% |

## FINANCIAL CONDITION

### Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $132.3 billion and $133.0 billion as of March 31, 2018 and June 30, 2017, respectively. Equity and other investments were $2.8 billion and $6.0 billion as of March 31, 2018 and June 30, 2017, respectively. Our short-term investments are primarily intended to facilitate liquidity and capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities.

As a result of the TCJA, our cash, cash equivalents, and short-term investments held by foreign subsidiaries are no longer subject to U.S. tax on repatriation into the U.S.

#### *Securities Lending*

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our consolidated balance sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash collateral received is recorded as an asset with a corresponding liability. Our average and maximum securities lending payable balances were $21 million and $71 million, respectively, for the three months ended March 31, 2018. Our average and maximum securities lending payable balances were $150 million and $600 million, respectively, for the nine months ended March 31, 2018. Intra-year variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

#### *Valuation*

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our financial instruments. This pricing methodology applies to our Level 1 investments, such as U.S. government securities, domestic and international equities, and mutual funds. 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, commercial paper, mortgage- and asset-backed securities, and certificates of deposit. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured at fair value on a recurring basis using unobservable inputs are an immaterial portion of our portfolio.

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

**Cash Flows**

Cash from operations increased $4.0 billion to $32.5 billion for the nine months ended March 31, 2018, mainly due to an increase in cash received from customers, offset in part by an increase in cash paid to employees, net cash paid for income taxes, cash paid for interest on debt, and cash paid to suppliers. Cash used in financing was $27.6 billion for the nine months ended March 31, 2018, compared to cash from financing of $11.1 billion for the nine months ended March 31, 2017. The change was mainly due to a $39.1 billion decrease in proceeds from issuance of debt, net of repayments, offset in part by a $1.7 billion decrease in cash used for common stock repurchases. Cash used in investing decreased $36.0 billion to $3.4 billion for the nine months ended March 31, 2018, mainly due to a $25.1 billion decrease in cash used for acquisitions of companies, net of cash acquired, and purchases of intangible and other assets, and a $12.7 billion increase in cash from net investment purchases, sales, and maturities.

**Debt**

We issued debt to take advantage of favorable pricing and liquidity in the debt markets, reflecting our credit rating and the low interest rate environment. The proceeds of these issuances were or will be used for general corporate purposes, which may include, among other things, funding for working capital, capital expenditures, repurchases of capital stock, acquisitions, and repayment of existing debt. Refer to Note 11 – Debt of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

**Unearned Revenue**

Unearned revenue comprises mainly unearned revenue related to volume licensing programs and includes Software Assurance (“SA”) and cloud services. Unearned revenue is generally billed upfront at the beginning of each annual coverage period for multi-year agreements and recognized ratably over the coverage period. Unearned revenue also includes payments for other offerings for which we have been paid in advance and earn the revenue when we transfer control of the product or service. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

The following table outlines the expected future recognition of unearned revenue as of March 31, 2018:

| **(In millions)** | |
|---|---|
| **Three Months Ending,** | |
| June 30, 2018 | $ 10,087 |
| September 30, 2018 | 5,573 |
| December 31, 2018 | 4,049 |
| March 31, 2019 | 1,661 |
| Thereafter | 2,585 |
| Total | $ 23,955 |

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

**Share Repurchases**

For the nine months ended March 31, 2018, we repurchased 78 million shares of our common stock for $6.5 billion through our share repurchase programs. All repurchases were made using cash resources. Refer to Note 17 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

**Dividends**

Refer to Note 17 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

**Off-Balance Sheet Arrangements**

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

**Other Planned Uses of Capital**

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology, as well as continue making acquisitions that align with our business strategy. Additions to property and equipment will continue, including new facilities, datacenters, and computer systems for research and development, sales and marketing, support, and administrative staff. We expect capital expenditures to increase in coming years to support growth in our cloud offerings. We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

**Liquidity**

As a result of the TCJA, we are required to pay a one-time transition tax of $17.8 billion on deferred foreign income not previously subject to U.S. income tax. Under the TCJA, the transition tax is payable beginning in fiscal year 2019 interest-free over eight years, with 8% due in each of the first five years, 15% in year six, 20% in year seven, and 25% in year eight.

We expect existing cash, cash equivalents, short-term investments, cash flows from operations, and access to capital markets to continue to be sufficient to fund our operating activities and cash commitments for investing and financing activities, such as dividends, share repurchases, debt maturities, material capital expenditures, and the transition tax related to the TCJA, for at least the next 12 months and thereafter for the foreseeable future.

## RECENT ACCOUNTING GUIDANCE

Refer to Note 1 – Accounting Policies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

## APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

**Revenue Recognition**

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

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

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

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

Our products are generally sold with a right of return and we may provide other credits or incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize.

The new standard related to revenue recognition had a material impact on our consolidated financial statements. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

**Impairment of Investment Securities**

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

**Goodwill**

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit.

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

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

**Research and Development Costs**

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

**Legal and Other Contingencies**

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

**Income Taxes**

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

The TCJA significantly changes existing U.S. tax law and includes numerous provisions that affect our business. Refer to Note 12 – Income Taxes of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

**Inventories**

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

# ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

## RISKS

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

**Foreign Currency**

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

**Interest Rate**

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

**Equity**

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

## 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 of America (“GAAP”), but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign exchange rates, interest rates, and equity prices, assuming normal market conditions.

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

The following table sets forth the one-day VaR for substantially all of our positions:

**(In millions)**

| | March 31, 2018 | June 30, 2017 | Three Months Ended March 31, 2018 | | |
|---|---|---|---|---|---|
| **Risk Categories** | | | **Average** | **High** | **Low** |
| Foreign currency | **$ 178** | $ 114 | **$ 181** | **$ 197** | **$ 160** |
| Interest rate | **163** | 152 | **173** | **179** | **163** |
| Equity | **30** | 54 | **26** | **30** | **25** |

Total one-day VaR for the combined risk categories was $254 million and $207 million as of March 31, 2018 and June 30, 2017, respectively. The total VaR is 31% and 35% less as of March 31, 2018 and June 30, 2017, respectively, than the sum of the separate risk categories in the table above due to the diversification benefit of the combination of risks.

# ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective.

There were no changes in our internal control over financial reporting during the quarter ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We implemented internal controls to ensure we adequately evaluated our contracts and properly assessed the impact of the new accounting standards related to revenue recognition and leases on our financial statements to facilitate their adoption on July 1, 2017. There were no significant changes to our internal control over financial reporting due to the adoption of the new standards.

## PART II. OTHER INFORMATION

# ITEM 1. LEGAL PROCEEDINGS

Refer to Note 16 – Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding legal proceedings in which we are involved.

# ITEM 1A. RISK FACTORS

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

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

***Competition in the technology sector***

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

***Competition among platforms, ecosystems, and devices***

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

- A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has succeeded with some consumer products such as personal computers, tablets, phones, gaming consoles, and wearables. Competitors pursuing this model also earn revenue from services integrated with the hardware and software platform. We also offer some vertically-integrated hardware and software products and services. To the extent we shift a portion of our business to a vertically integrated model we increase our cost of revenue and reduce our operating margins.
- We derive substantial revenue from licenses of Windows operating systems on personal computers. We face significant competition from competing platforms developed for new devices and form factors such as smartphones and tablet computers. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users are increasingly turning to these devices to perform functions that in the past were performed by personal computers. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract application developers to our PC operating system platforms. Competing with operating systems licensed at low or no cost may decrease our PC operating system margins. In addition, some of our devices compete with products made by our original equipment manufacturer (“OEM”) partners, which may affect their commitment to our platform.
- Competing platforms have content and application marketplaces with scale and significant installed bases. The variety and utility of content and applications available on a platform are important to device purchasing decisions. Users sometimes incur costs to move data and buy new content and applications when switching platforms. To compete, we must successfully enlist developers to write applications for our marketplace and ensure that these applications have high quality, customer appeal, and value. Efforts to compete with competitors’ content and application marketplaces may increase our cost of revenue and lower our operating margins.

***Business model competition***

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

- Even as we transition more of our business to a services and subscription business model, the license-based proprietary software model generates most of our software revenue. We bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from licensing our products. Many of our competitors also develop and sell software to businesses and consumers under this model.
- Other competitors develop and offer free applications, online services and content, and make money by selling third-party advertising. Advertising revenue funds development of products and services these competitors provide to users at no or little cost, competing directly with our revenue-generating products.
- Some companies compete with us using an open source business model by modifying and then distributing open source software at nominal cost to end-users, and earning revenue on advertising or complementary services and products. These firms do not bear the full costs of research and development for the software. Some open source software vendors develop software that mimics the features and functionality of our products.

The competitive pressures described above may cause decreased sales volumes, price reductions, and/or increased operating costs, such as for research and development, marketing, and sales incentives. This may lead to lower revenue, gross margins, and operating income.

**Our increasing focus on services presents execution and competitive risks.** A growing part of our business involves cloud-based services available across the spectrum of computing devices. Our strategic vision is to compete and grow by building best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence. At the same time, our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud and sometimes the user's choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our cloud-based strategies. The Windows ecosystem must continue to evolve with this changing environment. We are undertaking cultural and organizational changes to drive accountability and eliminate obstacles to innovation. The Company's investment in gaining insights from data is becoming central to the value of the services we deliver to customers, to our operational efficiency and key opportunities in monetization, customer perceptions of quality, and operational efficiency. Our ability to use data in this way may be constrained by regulatory developments that impede realizing the expected return from this investment.

Besides software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs will reduce the operating margins we have previously achieved. Whether we succeed in cloud-based services depends on our execution in several areas, including:

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

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

**We make significant investments in new products and services that may not achieve expected returns.** We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows operating system, Microsoft Office, Bing, SQL Server, Windows Server, the Windows Store, Microsoft Azure, Office 365, other cloud-based offerings, Xbox Live, and LinkedIn. We also invest in the development and acquisition of a variety of hardware for productivity, communication, and entertainment including PCs, tablets, gaming devices, and HoloLens. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software and hardware products or upgrades, unfavorably affecting revenue. We may not achieve significant revenue from new product, service, and distribution channel investments for several years, if at all. New products and services may not be profitable, and even if they are profitable, operating margins for some new products and businesses will not be as high as the margins we have experienced historically.

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

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

**Acquisitions, joint ventures, and strategic alliances may have an adverse effect on our business.** We expect to continue making acquisitions and entering into joint ventures and strategic alliances as part of our long-term business strategy. In December 2016, we completed our acquisition of LinkedIn for $27.0 billion. The LinkedIn acquisition and other transactions and arrangements involve significant challenges and risks, including that they do not advance our business strategy, that we get an unsatisfactory return on our investment, that we have difficulty integrating and retaining new employees, business systems, and technology, or that they distract management from our other businesses. If an arrangement fails to adequately anticipate changing circumstances and interests of a party, it may result in early termination or renegotiation of the arrangement. The success of these transactions and arrangements will depend in part on our ability to leverage them to enhance our existing products and services or develop compelling new ones. It may take longer than expected to realize the full benefits from these transactions and arrangements, such as increased revenue, enhanced efficiencies, or increased market share, or the benefits may ultimately be smaller than we expected. These events could adversely affect our operating results or financial condition.

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

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

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

Protecting our intellectual property rights and combating unlicensed copying and use of our software and other intellectual property on a global basis is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. Our revenue in these markets may grow slower than the underlying device market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we educate users about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

***We may not receive expected royalties from our patent licenses***

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

**Third parties may claim we infringe their intellectual property rights.** From time to time, others claim we infringe their intellectual property rights. The number of these claims may grow because of constant technological change in the markets in which we compete, the extensive patent coverage of existing technologies, the rapid rate of issuance of new patents, and our offering of first-party devices, such as Surface. To resolve these claims, we may enter into royalty and licensing agreements on terms that are less favorable than currently available, stop selling or redesign affected products or services, or pay damages to satisfy indemnification commitments with our customers. These outcomes may cause operating margins to decline. Besides money damages, in some jurisdictions plaintiffs can seek injunctive relief that may limit or prevent importing, marketing, and selling our products or services that have infringing technologies. In some countries, such as Germany, an injunction can be issued before the parties have fully litigated the validity of the underlying patents. We have paid significant amounts to settle claims related to the use of technology and intellectual property rights and to procure intellectual property rights as part of our strategy to manage this risk, and may continue to do so.

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

**We may not be able to protect information on our products and services from use by others**. LinkedIn and other Microsoft products and services contain valuable information and content protected by contractual restrictions or technical measures. In certain cases, we have made commitments to our members and users to limit access to or use of this information. Changes in the law or interpretations of the law may weaken our ability to prevent third parties from scraping or gathering information or content through use of bots or other measures and using it for their own benefit, thus diminishing the value of our products and services.

**Cyberattacks and security vulnerabilities could lead to reduced revenue, increased costs, liability claims, or harm to our reputation or competitive position.**

***Security of our information technology***

Threats to IT security can take a variety of forms. Individual and groups of hackers and sophisticated organizations, including state-sponsored organizations or nation-states, continuously undertake attacks that pose threats to our customers and our IT. These actors may use a wide variety of methods, which may include developing and deploying malicious software or exploiting vulnerabilities in hardware, software, or other infrastructure in order to attack our products and services or gain access to our networks and datacenters, using social engineering techniques to induce our employees, users, partners, or customers to disclose passwords or other sensitive information or take other actions to gain access to our data or our users' or customers' data, or acting in a coordinated manner to launch distributed denial of service or other coordinated attacks. Inadequate account security practices may also result in unauthorized access to confidential data. For example, system administrators may fail to timely remove employee account access when no longer appropriate. Cyberthreats are constantly evolving, increasing the difficulty of detecting and successfully defending against them. Cyberthreats can have cascading impacts that unfold with increasing speed across our internal networks and systems and those of our partners and customers. Breaches of our network or data security could disrupt the security of our systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, result in product development delays, compromise confidential or technical business information harming our reputation or competitive position, result in theft or misuse of our intellectual property or other assets, require us to allocate more resources to improved technologies, or otherwise adversely affect our business.

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

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

The security of our products and services is important in our customers' decisions to purchase or use our products or services. Security threats are a significant challenge to companies like us whose business is providing technology products and services to others. Threats to our own IT infrastructure can also affect our customers. Customers using our cloud-based services rely on the security of our infrastructure, including hardware and other elements provided by third parties, to ensure the reliability of our services and the protection of their data. Hackers tend to focus their efforts on the most popular operating systems, programs, and services, including many of ours, and we expect that to continue. Hackers that acquire user account information at other companies can use that information to compromise our users' accounts where accounts share the same attributes like passwords. Inadequate account security practices may also result in unauthorized access. We are also increasingly incorporating open source software into our products. There may be vulnerabilities in open source software that may make our products susceptible to cyberattacks.

To defend against security threats to our internal IT systems, our cloud-based services, and our customers' systems, we must continuously engineer more secure products and services, enhance security and reliability features, improve the deployment of software updates to address security vulnerabilities in our own products as well as those provided by others, develop mitigation technologies that help to secure customers from attacks even when software updates are not deployed, maintain the digital security infrastructure that protects the integrity of our network, products, and services, and provide customers security tools such as firewalls and anti-virus software and information about the need to deploy security measures and the impact of doing so.

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

As illustrated by the recent Spectre and Meltdown threats, our products operate in conjunction with and are dependent on products and components across a broad ecosystem. If there is a security vulnerability in one of these components, and if there is a security exploit targeting it, we could face increased costs, liability claims, reduced revenue, or harm to our reputation or competitive position.

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

**Abuse of our advertising or social platforms may harm our reputation or user engagement.** For LinkedIn, Bing Ads, and other products and services that provide content or host ads that come from or can be influenced by third parties, our reputation or user engagement may be negatively affected by activity that is hostile or inappropriate to other people, by users impersonating other people or organizations, by use of our products or services to disseminate information that may be viewed as misleading or intended to manipulate the opinions of our users, or by the use of our products or services that violates our terms of service or otherwise for objectionable or illegal ends. Preventing these actions may require us to make substantial investments in people and technology and these investments may not be successful, adversely affecting our business and financial results.

**We may have excessive outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure.** Our increasing user traffic, growth in services, and the complexity of our products and services demand more computing power. We spend substantial amounts to build, purchase, or lease datacenters and equipment and to upgrade our technology and network infrastructure to handle more traffic on our websites and in our datacenters. These demands continue to increase as we introduce new products and services and support the growth of existing services such as Bing, Exchange Online, Microsoft Azure, Microsoft Account services, Office 365, OneDrive, SharePoint Online, Skype, Xbox Live, Outlook.com, and Windows Stores. We are rapidly growing our business of providing a platform and back-end hosting for services provided by third parties to their end users. Maintaining, securing, and expanding this infrastructure is expensive and complex. It requires that we maintain an Internet connectivity infrastructure that is robust and reliable within competitive and regulatory constraints that continue to evolve. Inefficiencies or operational failures, including temporary or permanent loss of customer data or insufficient Internet connectivity, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers

and other third parties, regulatory actions, damage to our reputation, and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

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

The European Commission ("the Commission") closely scrutinizes the design of high-volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. Flagship product releases such as Windows 10 can receive significant scrutiny under competition laws. For example, in 2004, the Commission ordered us to create new versions of our Windows operating system that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. In 2009, the Commission accepted a set of commitments we offered to address the Commission's concerns relating to competition in web browsing software, including an undertaking to address Commission concerns relating to interoperability. The web browsing commitments expired in 2014. The remaining obligations may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our products, which could hamper sales of our products.

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

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

- We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail a delay in a product release and removing functionality that customers want or on which developers rely.
- We may be required to make available licenses to our proprietary technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.
- The rulings described above may be precedent in other competition law proceedings.
- We are subject to a variety of ongoing commitments because of court or administrative orders, consent decrees, or other voluntary actions we have taken. If we fail to comply with these commitments, we may incur litigation costs and be subject to substantial fines or other remedial actions.
- Our ability to realize anticipated Windows 10 post-sale monetization opportunities may be limited.

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

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

**Laws and regulations relating to the handling of personal data may impede the adoption of our services or result in increased costs, legal claims, or fines against us.** The growth of our Internet- and cloud-based services internationally relies increasingly on the movement of data across national boundaries. Legal requirements relating to the collection, storage, handling, and transfer of personal data continue to evolve. For example, the EU and the U.S. formally entered into a new framework in July 2016 that provides a mechanism for companies to transfer data from EU member states to the U.S. This framework, called the Privacy Shield, is intended to address shortcomings identified by the European Court of Justice in a predecessor mechanism. The Privacy Shield and other mechanisms are currently subject to challenges in European courts, which may lead to uncertainty about the legal basis for data transfers across the Atlantic. In 2016, the EU adopted a new law governing data practices and privacy called the General Data Protection Regulation ("GDPR"), which becomes effective in May 2018. The law requires firms to meet new requirements regarding the handling of personal data. Engineering efforts to build new capabilities to facilitate compliance with the law may entail substantial expense and the diversion of engineering resources from other projects. If we are unable to engineer products that meet our legal duties or help our customers meet their obligations under the GDPR or other data regulations, we might experience reduced demand for our offerings. Compliance with data regulations might limit our ability to innovate or offer certain features and functionality in some jurisdictions where we operate. Non-compliance with the GDPR may lead to regulatory enforcement actions, which can result in monetary penalties of up to 4% of worldwide revenue, or private lawsuits.

Ongoing legal reviews by regulators may result in burdensome or inconsistent requirements affecting the location and movement of our customer and internal employee data as well as the management of that data. Compliance may require changes in services, business practices, or internal systems that result in increased costs, lower revenue, reduced efficiency, or greater difficulty in competing with foreign-based firms. Failure to comply with existing or new rules may result in significant penalties or orders to stop the alleged noncompliant activity.

**Our business depends on our ability to attract and retain talented employees.** Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. Changes to U.S. immigration policies that restrain the flow of technical and professional talent may inhibit our ability to adequately staff our research and development efforts. If we are less successful in our recruiting efforts, or if we cannot retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution. How employment-related laws are interpreted and applied to our workforce practices may result in increased operating costs and less flexibility in how we meet our workforce needs.

**We have claims and lawsuits against us that may result in adverse outcomes.** We are subject to a variety of claims and lawsuits. These claims may arise from a wide variety of business practices and initiatives, including major new product releases such as Windows 10, significant business transactions, warranty or product claims, and employment practices. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. The litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. A material adverse impact on our consolidated financial statements could occur for the period in which the effect of an unfavorable outcome becomes probable and reasonably estimable.

**We may have additional tax liabilities.** We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. For example, compliance with the 2017 United States Tax Cut and Jobs Act ("TCJA") may require the collection of information not regularly

produced within the Company, the use of estimates in our financial statements, and the exercise of significant judgment in accounting for its provisions. As regulations and guidance evolve with respect to TCJA, and as we gather more information and perform more analysis, our results may differ from previous estimates and may materially affect our financial position.

We regularly are under audit by tax authorities in different jurisdictions. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes favorably more difficult. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation in the jurisdictions where we are subject to taxation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our consolidated financial statements in the period or periods in which that determination is made.

We earn a significant amount of our operating income outside the U.S.; a change in the mix of earnings and losses in countries with differing statutory tax rates, changes in our business or structure, or the expiration of or disputes about certain tax agreements in a particular country may result in higher effective tax rates for the Company. In addition, changes in U.S. federal and state or international tax laws applicable to corporate multinationals, other fundamental law changes currently being considered by many countries, including in the U.S., and changes in taxing jurisdictions' administrative interpretations, decisions, policies, and positions may materially adversely impact our tax expense and cash flows.

**We may experience quality or supply problems.** Our vertically-integrated hardware products such as Xbox consoles, Surface devices, and other devices we design, manufacture, and market are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm as a result of recalls, safety alerts, or product liability claims if we fail to prevent, detect, or address such issues through design, testing, or warranty repairs.

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

We acquire some device and datacenter components from sole suppliers. Our competitors use some of the same suppliers and their demand for hardware components can affect the capacity available to us. If a component from a sole-source supplier is delayed or becomes unavailable, whether because of supplier capacity constraint or industry shortages, we may not obtain timely replacement supplies, resulting in reduced sales or inadequate datacenter capacity. Component shortages, excess or obsolete inventory, or price reductions resulting in inventory adjustments may increase our cost of revenue. Xbox consoles, Surface devices, datacenter servers, and other hardware are assembled in Asia and other geographies that may be subject to disruptions in the supply chain, resulting in shortages that would affect our revenue and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

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

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

**Catastrophic events or geopolitical conditions may disrupt our business.** A disruption or failure of our systems or operations because of a major earthquake, weather event, cyberattack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other essential business operations are in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are seismically active regions. A catastrophic event that results in the destruction or disruption of any of our critical business or IT systems could harm our ability to conduct normal business operations. Providing our customers with more services and

solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged service outages on our operating results.

Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may cause supply chain disruptions for hardware manufacturers. Geopolitical change may result in changing regulatory requirements that could impact our operating strategies, access to global markets, hiring, and profitability. Geopolitical instability may lead to sanctions and impact our ability to do business in some markets or with some public-sector customers. Emerging nationalist trends in specific countries may significantly alter the trade environment. Changes to trade policy or agreements may result in higher tariffs, local sourcing initiatives, or other developments that make it more difficult to sell our products in foreign countries. Any of these changes may negatively impact our revenues.

The long-term effects of climate change on the global economy or the IT industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy or other natural resources may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services.

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

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

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

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

**Changes in our sales organization may impact revenues.** In July 2017, we announced plans to reorganize our global sales organization to help enable customers' digital transformation, add greater technical ability to our sales force, and create pooled resources that can be used across countries and industries. The reorganization is the most significant change in our global sales organization in our history, involving employees changing roles, adding additional talent, realigning teams, and onboarding new partners. Successfully executing these changes will be a significant factor in enabling future revenue growth. As we navigate through this transition, sales, profitability, and cash flow could be adversely impacted.

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

DIVIDENDS AND SHARE REPURCHASES

Refer to Note 17 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion regarding dividends and share repurchases. Following are our monthly stock repurchases for the third quarter of fiscal year 2018:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs |
|---|---|---|---|---|
| | | | | (in millions) |
| January 1, 2018 – January 31, 2018 | 6,838,966 | $ 89.91 | 6,838,966 | $ 32,785 |
| February 1, 2018 – February 28, 2018 | 12,389,259 | 91.16 | 12,389,259 | 31,656 |
| March 1, 2018 – March 31, 2018 | 14,573,553 | 93.02 | 14,573,553 | 30,300 |
| | 33,801,778 | | 33,801,778 | |

All repurchases were made using cash resources. Our stock repurchases may occur through open market purchases or pursuant to a Rule 10b5-1 trading plan. The above table excludes shares repurchased to settle employee tax withholding related to the vesting of stock awards.

# ITEM 5. OTHER INFORMATION

Effective April 23, 2018, the Company approved forms of stock award agreement under the Microsoft Corporation 2017 Stock Plan for grants to participants in the Company's Executive Incentive Plan, including executive officers. The forms of award agreement are for service-based awards and performance-based awards. These award agreements are based on the forms of executive officer award agreement previously used under the Company's 2001 Stock Plan, which is no longer used for executive officer grants, excluding previous agreement provisions relating to Section 162(m) of the Internal Revenue Code.

The summary is qualified by the text of the award agreements, copies of which are filed as exhibits 10.26 and 10.27 to this report.

# ITEM 6. EXHIBITS

| | |
|---|---|
| 10.26* | Form of Stock Award Agreement Under the Microsoft Corporation 2017 Stock Plan |
| 10.27* | Form of Performance Stock Award Agreement Under the Microsoft Corporation 2017 Stock Plan |
| 15.1 | 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 |

* *Indicates a management contract or compensatory plan or arrangement*

** *Furnished, not filed*

**Items 3 and 4 are not applicable and have been omitted.**

## SIGNATURE

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

MICROSOFT CORPORATION

/S/ FRANK H. BROD

Frank H. Brod
Corporate Vice President, Finance and Administration;
Chief Accounting Officer (Duly Authorized Officer)

April 26, 2018