MICROSOFT CORP
Form 10-Q
January 28, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended December 31, 2009

OR

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

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

(425) 882-8080

(Registrant s telephone number, including area code)

None

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

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

Indicate by check mark whether the registrant 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 x No ¨

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

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

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

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

Class	**Outstanding at January 25, 2010**
Common Stock, $0.00000625 par value per share	8,770,460,922 shares

Table of Contents

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2009

INDEX

			Page
PART I.	**FINANCIAL INFORMATION**		
	Item 1.	Financial Statements	
		a) Income Statements for the Three and Six Months Ended December 31, 2009 and 2008	3
		b) Balance Sheets as of December 31, 2009 and June 30, 2009	4
		c) Cash Flows Statements for the Three and Six Months Ended December 31, 2009 and 2008	5
		d) Stockholders Equity Statements for the Three and Six Months Ended December 31, 2009 and 2008	6
		e) Notes to Financial Statements	7
		f) Report of Independent Registered Public Accounting Firm	26
	Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	27
	Item 3.	Quantitative and Qualitative Disclosures About Market Risk	42
	Item 4.	Controls and Procedures	43
PART II.	**OTHER INFORMATION**		
	Item 1.	Legal Proceedings	43
	Item 1A.	Risk Factors	44
	Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	49
	Item 4.	Submission of Matters to a Vote of Security Holders	49
	Item 6.	Exhibits	51
SIGNATURE			52

Table of Contents

PART I

Item 1

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	**2008**	**2009**	**2008**
Revenue	**$ 19,022**	$ 16,629	**$ 31,942**	$ 31,690
Operating expenses:				
Cost of revenue	**3,628**	3,907	**6,470**	6,755
Research and development	**2,079**	2,290	**4,144**	4,573
Sales and marketing	**3,619**	3,662	**6,409**	6,706
General and administrative	**1,124**	831	**1,865**	1,718
Employee severance	**59**		**59**	
Total operating expenses	**10,509**	10,690	**18,947**	19,752
Operating income	**8,513**	5,939	**12,995**	11,938
Other income (expense)	**370**	(301)	**653**	(309)
Income before income taxes	**8,883**	5,638	**13,648**	11,629
Provision for income taxes	**2,221**	1,464	**3,412**	3,082
Net income	**$ 6,662**	$ 4,174	**$ 10,236**	$ 8,547
Earnings per share:				
Basic	**$ 0.75**	$ 0.47	**$ 1.15**	$ 0.95
Diluted	**$ 0.74**	$ 0.47	**$ 1.14**	$ 0.94
Weighted average shares outstanding:				
Basic	**8,856**	8,903	**8,885**	8,994
Diluted	**8,951**	8,914	**8,975**	9,052
Cash dividends declared per common share	**$ 0.13**	$ 0.13	**$ 0.26**	$ 0.26

See accompanying notes.

Table of Contents

PART I

Item 1

BALANCE SHEETS

(In millions)	December 31, 2009 (Unaudited)	June 30, 2009 (1)
Assets		
Current assets:		
Cash and cash equivalents	**$ 9,422**	$ 6,076
Short-term investments (including securities loaned of **$2,654** and $1,540)	**26,677**	25,371
Total cash, cash equivalents, and short-term investments	**36,099**	31,447
Accounts receivable, net of allowance for doubtful accounts of **$506** and $451	**11,196**	11,192
Inventories	**589**	717
Deferred income taxes	**2,056**	2,213
Other	**2,547**	3,711
Total current assets	**52,487**	49,280
Property and equipment, net of accumulated depreciation of **$8,170** and $7,547	**7,402**	7,535
Equity and other investments	**6,976**	4,933
Goodwill	**12,368**	12,503
Intangible assets, net	**1,346**	1,759
Deferred income taxes		279
Other long-term assets	**1,517**	1,599
Total assets	**$ 82,096**	$ 77,888
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,171**	$ 3,324
Short-term debt	**2,249**	2,000
Accrued compensation	**2,417**	3,156
Income taxes	**721**	725
Short-term unearned revenue	**11,361**	13,003
Securities lending payable	**2,911**	1,684
Other	**2,885**	3,142
Total current liabilities	**25,715**	27,034
Long-term debt	**3,746**	3,746
Long-term unearned revenue	**1,167**	1,281
Deferred income taxes	**377**	
Other long-term liabilities	**6,808**	6,269
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **8,811** and 8,908	**62,566**	62,382
Retained deficit, including accumulated other comprehensive income of **$1,322** and $969	**(18,283)**	(22,824)

Total stockholders equity	**44,283**	39,558
Total liabilities and stockholders equity	**$ 82,096**	$ 77,888

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

Table of Contents

PART I

Item 1

CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	**2008**	**2009**	**2008**
Operations				
Net income	**$ 6,662**	$ 4,174	**$ 10,236**	$ 8,547
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other noncash items	**615**	632	**1,261**	1,217
Stock-based compensation	**485**	417	**928**	860
Net recognized losses (gains) on investments and derivatives	**(188)**	139	**(254)**	175
Excess tax benefits from stock-based compensation	**(15)**	(2)	**(24)**	(46)
Deferred income taxes	**550**	454	**504**	830
Deferral of unearned revenue	**6,926**	5,969	**13,605**	10,155
Recognition of unearned revenue	**(9,126)**	(6,364)	**(15,363)**	(12,408)
Changes in operating assets and liabilities:				
Accounts receivable	**(2,789)**	(1,647)	**(41)**	2,338
Other current assets	**1,244**	797	**590**	239
Other long-term assets	**16**	(69)	**(62)**	(185)
Other current liabilities	**285**	614	**(954)**	(3,938)
Other long-term liabilities	**304**	668	**650**	1,368
Net cash from operations	**4,969**	5,782	**11,076**	9,152
Financing				
Short-term borrowings (repayments), maturities of 90 days or less, net	**(475)**	21	**(97)**	1,996
Proceeds from issuance of debt, maturities longer than 90 days	**1,046**		**1,741**	
Repayments of debt, maturities longer than 90 days	**(573)**		**(1,396)**	
Common stock issued	**729**	96	**977**	324
Common stock repurchased	**(3,867)**	(2,820)	**(5,407)**	(9,313)
Common stock cash dividends	**(1,152)**	(1,157)	**(2,309)**	(2,155)
Excess tax benefits from stock-based compensation	**15**	2	**24**	46
Net cash used in financing	**(4,277)**	(3,858)	**(6,467)**	(9,102)
Investing				
Additions to property and equipment	**(376)**	(842)	**(811)**	(1,620)
Acquisition of companies, net of cash acquired	**(63)**	(450)	**(102)**	(827)
Purchases of investments	**(4,287)**	(6,596)	**(14,777)**	(10,842)
Maturities of investments	**1,896**	290	**5,394**	754
Sales of investments	**3,361**	5,700	**7,778**	12,775
Securities lending payable	**(623)**	(601)	**1,227**	(2,144)
Net cash used in investing	**(92)**	(2,499)	**(1,291)**	(1,904)
Effect of exchange rates on cash and cash equivalents	**(1)**	(83)	**28**	(139)

Net change in cash and cash equivalents	**599**	(658)	**3,346**	(1,993)
Cash and cash equivalents, beginning of period	**8,823**	9,004	**6,076**	10,339
Cash and cash equivalents, end of period	**$ 9,422**	$ 8,346	**$ 9,422**	$ 8,346

See accompanying notes.

Table of Contents

PART I

Item 1

STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	**2008**	**2009**	**2008**
Common stock and paid-in capital				
Balance, beginning of period	**$ 62,293**	$ 61,655	**$ 62,382**	$ 62,849
Common stock issued	**779**	86	**1,027**	312
Common stock repurchased	**(923)**	(674)	**(1,656)**	(2,571)
Stock-based compensation	**485**	417	**928**	860
Stock-based compensation income tax deficiencies	**(68)**	(91)	**(114)**	(58)
Other, net		(1)	**(1)**	
Balance, end of period	**62,566**	61,392	**62,566**	61,392
Retained deficit				
Balance, beginning of period	**(21,081)**	(28,061)	**(22,824)**	(26,563)
Net income	**6,662**	4,174	**10,236**	8,547
Other comprehensive income:				
Net unrealized gains (losses) on derivatives	**(42)**	473	**(361)**	766
Net unrealized gains (losses) on investments	**65**	(514)	**653**	(912)
Translation adjustments and other	**(35)**	(251)	**61**	(409)
Comprehensive income	**6,650**	3,882	**10,589**	7,992
Common stock cash dividends	**(1,140)**	(1,147)	**(2,297)**	(2,304)
Common stock repurchased	**(2,712)**	(1,588)	**(3,751)**	(6,039)
Balance, end of period	**(18,283)**	(26,914)	**(18,283)**	(26,914)
Total stockholders equity	**$ 44,283**	$ 34,478	**$ 44,283**	$ 34,478

See accompanying notes.

Table of Contents

PART I

Item 1

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Basis of Presentation

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

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 2009 Form 10-K filed on July 30, 2009 with the U.S. Securities and Exchange Commission.

Principles of Consolidation

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

Subsequent Events

We evaluated events occurring between the end of our fiscal quarter, December 31, 2009 and January 28, 2010 when the financial statements were issued.

Recently Adopted Accounting Guidance

On July 1, 2009, we adopted guidance issued by the Financial Accounting Standards Board (FASB) on business combinations. The guidance retains the fundamental requirements that the acquisition method of accounting (previously referred to as the purchase method of accounting) be used for all business combinations, but requires a number of changes, including changes in the way assets and liabilities are recognized and measured as a result of business combinations. It also requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. We have applied this guidance to business combinations completed since July 1, 2009.

On July 1, 2009, we adopted the guidance issued by the FASB that changes the accounting and reporting for non-controlling interests. Non-controlling interests are to be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control are to be accounted for as equity transactions. In addition, net income attributable to a non-controlling interest is to be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, is to be recorded at fair value with any gain or loss recognized in net income. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2009, we adopted the guidance on fair value measurement for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Adoption of the new guidance did not have a material impact on our financial statements.

Table of Contents

PART I

Item 1

Recent Accounting Guidance Not Yet Adopted

In January 2010, the FASB issued guidance to amend the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, adoption of this new guidance will not have a material impact on our financial statements.

In October 2009, the FASB issued guidance on revenue recognition that will become effective for us beginning July 1, 2010, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe adoption of this new guidance will not have a material impact on our financial statements.

In June 2009, the FASB issued guidance on the consolidation of variable interest entities, which is effective for us beginning July 1, 2010. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. We believe adoption of this new guidance will not have a material impact on our financial statements.

NOTE 2 EARNINGS PER SHARE

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options, stock awards, and shared performance stock awards. The components of basic and diluted earnings per share are as follows:

(In millions, except earnings per share)	**Three Months Ended December 31,**		**Six Months Ended December 31,**	
	2009	**2008**	**2009**	**2008**
Net income available for common shareholders (A)	**$ 6,662**	$ 4,174	**$ 10,236**	$ 8,547
Weighted average shares of common stock outstanding (B)	**8,856**	8,903	**8,885**	8,994
Dilutive effect of stock-based awards	**95**	11	**90**	58
Common stock and common stock equivalents (C)	**8,951**	8,914	**8,975**	9,052
Earnings per share:				
Basic (A/B)	**$ 0.75**	$ 0.47	**$ 1.15**	$ 0.95
Diluted (A/C)	**$ 0.74**	$ 0.47	**$ 1.14**	$ 0.94

We excluded the following shares underlying stock-based awards from the calculations of diluted earnings per share because their inclusion would have been anti-dilutive:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Shares excluded from calculations of diluted EPS	**101**	517	**155**	326

Table of Contents

PART I

Item 1

NOTE 3 OTHER INCOME (EXPENSE)

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Dividends and interest	$ 159	$ 175	$ 324	$ 382
Net recognized gains on investments	92	270	162	399
Net gains (losses) on derivatives	96	(409)	92	(574)
Net gains (losses) on foreign currency remeasurements	(23)	(350)	32	(529)
Other	46	13	43	13
Total	$ 370	$ (301)	$ 653	$ (309)

Other-than-temporary impairments included in net recognized gains on investments were $6 million and $24 million for the three months and six months ended December 31, 2009, respectively, as compared with $262 million and $334 million during the three months and six months ended December 31, 2008, respectively.

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
December 31, 2009							
Cash	$ 2,151	$	$	$ 2,151	$ 2,151	$	$
Mutual funds	1,713			1,713	1,662	51	
Commercial paper	2,440			2,440	1,816	624	
Certificates of deposit	3,292			3,292	3,058	234	
U.S. government and agency securities	12,542	50	(9)	12,583	415	12,168	
Foreign government bonds	3,530	84	(3)	3,611		3,611	
Mortgage-backed securities	3,981	91	(4)	4,068		4,068	
Corporate notes and bonds	5,411	288	(14)	5,685	200	5,485	
Municipal securities	539	1	(2)	538	120	418	
Common and preferred stock	5,171	1,432	(116)	6,487			6,487
Other investments	507			507		18	489

Total	**$ 41,277**	**$ 1,946**	**$ (148)**	**$ 43,075**	**$ 9,422**	**$ 26,677**	**$ 6,976**

Table of Contents

PART I

Item 1

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2009							
Cash	$ 2,064	$	$	$ 2,064	$ 2,064	$	$
Mutual funds	1,007		(25)	982	900	82	
Commercial paper	2,601			2,601	400	2,201	
Certificates of deposit	555			555	275	280	
U.S. government and agency securities	13,450	21	(5)	13,466	2,369	11,097	
Foreign government bonds	3,450	71	(4)	3,517		3,517	
Mortgage-backed securities	3,353	81	(16)	3,418		3,418	
Corporate notes and bonds	4,361	287	(52)	4,596		4,596	
Municipal securities	255	2	(1)	256	68	188	
Common and preferred stock	4,015	627	(182)	4,460			4,460
Other investments	465			465		(8)	473
Total	$ 35,576	$ 1,089	$ (285)	$ 36,380	$ 6,076	$ 25,371	$ 4,933

Unrealized Losses on Investments

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

	Less than 12 Months		12 Months or Greater		Total	
(In millions)	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Total Fair Value**	**Unrealized Losses**
December 31, 2009						
U.S. government and agency securities	**$ 568**	**$ (9)**	**$**	**$**	**$ 568**	**$ (9)**
Foreign government bonds	**1,395**	**(1)**	**491**	**(2)**	**1,886**	**(3)**
Mortgage-backed securities	**391**	**(2)**	**20**	**(2)**	**411**	**(4)**
Corporate notes and bonds	**397**	**(5)**	**183**	**(9)**	**580**	**(14)**
Municipal securities	**110**	**(2)**			**110**	**(2)**
Common and preferred stock	**887**	**(58)**	**243**	**(58)**	**1,130**	**(116)**
Total	**$ 3,748**	**$ (77)**	**$ 937**	**$ (71)**	**$ 4,685**	**$ (148)**

	Less than 12 Months		12 Months or Greater		Total	
(In millions)	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Total Fair Value**	**Unrealized Losses**

June 30, 2009

Mutual funds	$ 3	$ (1)	$ 77	$ (24)	$ 80	$ (25)
U.S. government and agency securities	4,033	(5)			4,033	(5)
Foreign government bonds	1,444	(3)	669	(1)	2,113	(4)
Mortgage-backed securities	503	(16)			503	(16)
Corporate notes and bonds	713	(10)	504	(42)	1,217	(52)
Municipal securities	16	(1)			16	(1)
Common and preferred stock	1,154	(135)	120	(47)	1,274	(182)
Total	$ 7,866	$ (171)	$ 1,370	$ (114)	$ 9,236	$ (285)

At December 31, 2009 and June 30, 2009, the recorded bases and estimated fair values of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $209 million and $204 million, respectively. The estimated fair values are based on publicly available market information or other estimates determined by management. Unrealized losses on fixed-income securities are primarily attributable to

Table of Contents

PART I

Item 1

changes in interest rates. Unrealized losses on domestic and international equities are due to market price movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of December 31, 2009.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
Due in one year or less	$ 9,837	$ 9,845
Due after one year through five years	14,945	15,240
Due after five years through 10 years	2,617	2,708
Due after 10 years	4,337	4,423
Total	$ 31,736	$ 32,216

NOTE 5 DERIVATIVES

We use derivative instruments to manage risks related to foreign currencies, equity prices, interest rates, and credit; to enhance investment returns; and to facilitate portfolio diversification. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the economic impact of these exposures as effectively as possible. Our derivative programs include strategies that both qualify and do not qualify for hedge accounting treatment. All notional amounts presented below are measured in U.S. currency equivalents.

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. Options and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash-flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. As of December 31, 2009, the total notional amount of such foreign exchange contracts sold was $9.1 billion. Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair-value hedging instruments. As of December 31, 2009, the total notional amount of these foreign exchange contracts sold was $3.7 billion. Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of December 31, 2009, the total notional amounts of these foreign exchange contracts purchased and sold were $4.5 billion and $4.6 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of December 31, 2009, the total notional amounts of designated and non-designated equity contracts purchased and sold were immaterial.

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of December 31, 2009, the total notional amount of fixed-interest rate contracts purchased and sold were $1.7 billion and $653 million, respectively. In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of December 31, 2009, the total notional derivative amount of mortgage contracts purchased was $858 million.

Table of Contents

PART I

Item 1

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low cost method of managing exposure to individual credit risks or groups of credit risks. As of December 31, 2009, the total notional amounts of credit contracts purchased and sold were immaterial.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swap and futures contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they are low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of December 31, 2009, the total notional amounts of commodity contracts purchased and sold were $692 million and $22 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain a minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of December 31, 2009, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral is required to be posted.

Fair Values of Derivative Instruments

Following are the gross fair values of derivative instruments held at December 31, 2009, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
Assets						
Derivatives not designated as hedging instruments:						
Short-term investments	$ 13	$ 112	$ 5	$ 7	$ 26	$ 163
Other current assets	80					80
Total	$ 93	$ 112	$ 5	$ 7	$ 26	$ 243
Derivatives designated as hedging instruments:						
Short-term investments	$ 87	$	$	$	$	$ 87
Other current assets	284					284
Total	$ 371	$	$	$	$	$ 371
Total assets	$ 464	$ 112	$ 5	$ 7	$ 26	$ 614

Table of Contents

PART I

Item 1

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
Liabilities						
Derivatives not designated as hedging instruments:						
Other current liabilities	$ (39)	$ (5)	$ (6)	$ (42)	$ (9)	$ (101)
Derivatives designated as hedging instruments:						
Other current liabilities	$ (103)	$	$	$	$	$ (103)
Total liabilities	$ (142)	$ (5)	$ (6)	$ (42)	$ (9)	$ (204)

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

Fair-Value Hedges

For a derivative instrument designated as a fair-value hedge, the gain (loss) is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributed to the risk being hedged. For options designated as fair-value hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings.

We recognized in other income (expense) the following gains (losses) on foreign exchange contracts designated as fair value hedges (our only fair value hedges during the period) and their related hedged items:

(In millions)	Three Months Ended December 31,	Six Months Ended December 31,
	2009	2009
Derivatives	$ 89	$ (104)
Hedged items	(85)	103
Total	$ 4	$ (1)

Cash-Flow Hedges

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

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

(In millions)	Three Months Ended December 31,	Six Months Ended December 31,
	2009	2009
Effective portion		
Gain (loss) recognized in OCI, net of tax effect of **$1** and **$(111)**	**$ 2**	**$ (207)**
Gain reclassified from accumulated OCI into revenue	**$ 68**	**$ 237**
Amount excluded from effectiveness assessment and ineffective portion		
Gain (loss) recognized in other income (expense)	**$ 26**	**$ (14)**

Table of Contents

PART I

Item 1

We estimate that $92 million of net derivative gains included in OCI will be reclassified into earnings within the next 12 months. No significant amounts of gains (losses) were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the three months and six months ended December 31, 2009.

Non-Designated Derivatives

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). These amounts are shown in the table below, with the exception of gains (losses) on derivatives presented in income statement line items other than other income (expense), which were immaterial for the three months and six months ended December 31, 2009. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are moved from OCI into other income (expense).

(In millions)	Three Months Ended December 31,	Six Months Ended December 31,
	2009	2009
Foreign exchange contracts	$ 47	$ 90
Equity contracts	7	16
Interest-rate contracts	9	12
Credit contracts	2	11
Commodity contracts	54	69
Total	$ 119	$ 198

NOTE 6 FAIR VALUE MEASUREMENTS

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

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

Level 2 inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and forward and spot prices for currencies and commodities. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, mortgage-backed securities, certificates of deposit, certain agency securities, foreign government bonds, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter options, futures, and swap contracts.

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

Table of Contents

PART I

Item 1

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present the fair values 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[1]	Net Fair Value
December 31, 2009						
Assets						
Mutual funds	**$ 1,713**	**$**	**$**	**$ 1,713**	**$**	**$ 1,713**
Commercial paper		**2,450**		**2,450**		**2,450**
Certificates of deposit		**3,292**		**3,292**		**3,292**
U.S. government and agency securities	**9,321**	**3,246**		**12,567**		**12,567**
Foreign government bonds	**472**	**3,050**		**3,522**		**3,522**
Mortgage-backed securities		**4,083**		**4,083**		**4,083**
Corporate notes and bonds		**5,381**	**192**	**5,573**		**5,573**
Municipal securities		**538**		**538**		**538**
Common and preferred stock	**6,233**	**39**	**5**	**6,277**		**6,277**
Derivatives	**22**	**588**	**4**	**614**	**(149)**	**465**
Total	**$ 17,761**	**$ 22,667**	**$ 201**	**$ 40,629**	**$ (149)**	**$ 40,480**
Liabilities						
Derivatives	**$ 7**	**$ 197**	**$**	**$ 204**	**$ (147)**	**$ 57**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[1]	Net Fair Value
June 30, 2009						
Assets						
Mutual funds	$ 982	$	$	$ 982	$	$ 982
Commercial paper		2,601		2,601		2,601
Certificates of deposit		555		555		555
U.S. government and agency securities	7,134	6,105		13,239		13,239
Foreign government bonds	501	3,022		3,523		3,523
Mortgage-backed securities		3,593		3,593		3,593
Corporate notes and bonds		4,073	253	4,326		4,326
Municipal securities		256		256		256
Common and preferred stock	4,218	28	5	4,251		4,251
Derivatives	5	623	5	633	(235)	398
Total	$ 12,840	$ 20,856	$ 263	$ 33,959	$ (235)	$ 33,724
Liabilities						

Derivatives	$ 5	$ 344	$	$ 349	$ (231)	$ 118

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

Table of Contents

PART I

Item 1

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

The following tables present the changes during the three months and six months ended December 31, 2009 and 2008 in our Level 3 financial instruments that are measured at fair value on a recurring basis. The majority of these instruments consist of investment securities classified as available-for-sale with changes in fair value included in other comprehensive income.

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three Months and Six Months Ended December 31, 2009				
Balance as of June 30, 2009	**$ 253**	**$ 5**	**$ 5**	**$ 263**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**1**		**(2)**	**(1)**
Included in other comprehensive income	**(74)**			**(74)**
Balance as of September 30, 2009	**$ 180**	**$ 5**	**$ 3**	**$ 188**
Total realized and unrealized gains:				
Included in other income (expense)	**1**		**1**	**2**
Included in other comprehensive income	**11**			**11**
Balance as of December 31, 2009	**$ 192**	**$ 5**	**$ 4**	**$ 201**
Change in unrealized gains (losses) included in other income (expense) for the three months ended December 31, 2009 related to assets held as of December 31, 2009	**$ 1**	**$**	**$ 1**	**$ 2**
Change in unrealized gains (losses) included in other income (expense) for the six months ended December 31, 2009 related to assets held as of December 31, 2009	**$ 2**	**$**	**$ (1)**	**$ 1**

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three Months and Six Months Ended December 31, 2008				
Balance as of June 30, 2008	$ 138	$ 8	$ 71	$ 217
Total realized and unrealized gains (losses):				
Included in other income (expense)	(9)	(4)	48	35
Included in other comprehensive income	(29)			(29)
Purchases, issuances, and settlements			(104)	(104)
Transfers in and out of Level 3	11			11
Balance as of September 30, 2008	$ 111	$ 4	$ 15	$ 130
Total realized and unrealized gains (losses):				
Included in other income (expense)	1	(2)		(1)

Included in other comprehensive income	10			10
Purchases, issuances, and settlements			(15)	(15)
Transfers in and out of Level 3	(1)			(1)
Balance as of December 31, 2008	$ 121	$ 2	$	$ 123
Change in unrealized gains (losses) included in other income (expense) for the three months ended December 31, 2008 related to assets held as of December 31, 2008	$	$ (2)	$	$ (2)
Change in unrealized gains (losses) included in other income (expense) for the six months ended December 31, 2008 related to assets held as of December 31, 2008	$ (9)	$ (5)	$ 1	$ (13)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

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

Table of Contents

PART I

Item 1

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. During the three months and six months ended December 31, 2009, we did not record any other-than-temporary impairments on those assets required to be measured at fair value on a non-recurring basis. The following table presents prior period balances for those assets required to be measured at fair value on a nonrecurring basis and the associated losses recognized during the three months and six months ended December 31, 2008:

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

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)	December 31, 2009	June 30, 2009
Raw materials	**$ 100**	$ 170
Work in process	**11**	45
Finished goods	**478**	502
Total	**$ 589**	$ 717

NOTE 8 BUSINESS COMBINATIONS

During the six months ended December 31, 2009, we acquired four entities for total consideration of $110 million, substantially all of which was paid in cash. During this period, we also sold three entities for total consideration of $602 million, including Razorfish in the second quarter of fiscal year 2010. These entities have been included in or removed from our consolidated results of operations since their acquisition or sale dates, respectively. Pro forma results of operations have not been presented because the effects of these business combinations, individually and in the aggregate, were not material to our consolidated results of operations.

NOTE 9 GOODWILL

Following are details of the changes in our goodwill balances during the three months and six months ended December 31, 2009:

(In millions)	Balance	Acquisitions	Purchase Accounting	Balance

	September 30, 2009		Adjustments and Other	December 31, 2009
Windows & Windows Live Division	$ 77	$	$	$ 77
Server and Tools	1,070	49		1,119
Online Services Division	6,633		(261)	6,372
Microsoft Business Division	3,998		(2)	3,996
Entertainment and Devices Division	804			804
Total	$ 12,582	$ 49	$ (263)	$ 12,368

Table of Contents

PART I

Item 1

(In millions)	Balance	Acquisitions	Purchase Accounting Adjustments and Other	Balance
	June 30, 2009			December 31, 2009
Windows & Windows Live Division	$ 77	$	$	$ 77
Server and Tools	1,038	82	(1)	1,119
Online Services Division	6,657		(285)	6,372
Microsoft Business Division	3,927	3	66	3,996
Entertainment and Devices Division	804			804
Total	$ 12,503	$ 85	$ (220)	$ 12,368

None of the amounts recorded as goodwill are expected to be deductible for tax purposes. The measurement period for purchase price allocations ends as soon as information on the facts and circumstances becomes available, but will not exceed 12 months. Adjustments in the purchase price allocation may require a recasting of the amounts allocated to goodwill retroactive to the period in which the acquisition occurred. Any change in the goodwill amounts resulting from foreign currency translations are presented as other in the table above. Also included within other is $263 million for the three months ended December 31, 2009 and $286 million for the six months ended December 31, 2009 of goodwill associated with business dispositions. See also Note 8.

In connection with the disposal of Razorfish, we performed an interim impairment analysis of our Online Services Division goodwill balance during the first quarter of fiscal year 2010. No impairment of goodwill was identified.

NOTE 10 INTANGIBLE ASSETS

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

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
	December 31, 2009			June 30, 2009		
Contract-based	$ 1,087	$ (884)	$ 203	$ 1,087	$ (855)	$ 232
Technology-based	2,158	(1,284)	874	2,033	(1,090)	943
Marketing-related	117	(78)	39	188	(97)	91
Customer-related	445	(215)	230	732	(239)	493
Total	$ 3,807	$ (2,461)	$ 1,346	$ 4,040	$ (2,281)	$ 1,759

We generally amortize acquired intangibles on a straight-line basis over their estimated weighted average lives. Intangible assets amortization expense was $169 million for the three months and $318 million for the six months ended December 31, 2009 as compared with $145 million for the three months and $285 million for the six months ended December 31, 2008. The following table outlines the estimated future amortization expense related to intangible assets held at December 31, 2009:

(In millions)	
Year Ending June 30,	
2010 (excluding the six months ended December 31, 2009)	$ 264
2011	509
2012	346
2013	205
2014 and thereafter	22
Total	$ 1,346

Table of Contents

PART I

Item 1

NOTE 11 DEBT

In September 2008, our Board of Directors authorized debt financings of up to $6.0 billion. Our initial commercial paper program provided for the issuance and sale of up to $2.0 billion. Following the issuance of our long-term debt in May 2009, we increased the commercial paper program and issued an additional $250 million of commercial paper during the six months ended December 31, 2009. As of December 31, 2009, we had $2.25 billion of commercial paper and $3.75 billion of long-term debt issued and outstanding.

Short-term Debt

As of December 31, 2009, our $2.25 billion of commercial paper issued and outstanding had a weighted average interest rate, including issuance costs, of 0.14% and maturities of 16 to 210 days. The estimated fair value of this commercial paper approximates its carrying value.

In November 2009, we replaced our $2.0 billion and $1.0 billion credit facilities with a $2.25 billion 364-day credit facility, which expires on November 5, 2010. This facility serves as a back-up for our commercial paper program. As of December 31, 2009, we were in compliance with the financial covenant in the credit facility, which requires a coverage ratio be maintained of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facilities during the six months ended December 31, 2009.

Long-term Debt

As of December 31, 2009, we had issued and outstanding $3.75 billion of debt securities as follows: $2.0 billion aggregate principal amount of 2.95% notes due 2014, $1.0 billion aggregate principal amount of 4.20% notes due 2019, and $750 million aggregate principal amount of 5.20% notes due 2039 (collectively the Notes). Interest on the Notes is payable semi-annually on June 1 and December 1 of each year to holders of record on the preceding May 15 and November 15. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

As of December 31, 2009, the total carrying value and estimated fair value of our long-term debt were $3.75 billion and $3.77 billion, respectively. The estimated fair value is based on quoted prices for our publicly-traded debt as of December 31, 2009.

NOTE 12 INCOME TAXES

Our effective tax rate was 25% for both the three months and six months ended December 31, 2009, as compared with 26% for the three months and 27% for the six months ended December 31, 2008. The fiscal year 2010 rate reflects a higher mix of foreign earnings taxed at lower rates.

Tax contingencies and other tax liabilities were $6.1 billion as of December 31, 2009 and $5.5 billion as of June 30, 2009, and were included in other long-term liabilities.

NOTE 13 UNEARNED REVENUE

The components of unearned revenue were as follows:

(In millions)	December 31, 2009	June 30, 2009
Volume licensing programs	**$ 10,058**	$ 11,350
Undelivered elements	**600**	1,083

Other	**1,870**	1,851
Total	**$ 12,528**	$ 14,284

Table of Contents

PART I

Item 1

Unearned revenue by segment was as follows:

(In millions)	December 31, 2009	June 30, 2009
Windows & Windows Live Division	**$ 1,736**	$ 2,345
Server and Tools	**4,227**	4,732
Microsoft Business Division	**5,680**	6,508
Other segments	**885**	699
Total	**$ 12,528**	$ 14,284

NOTE 14 PRODUCT WARRANTIES

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

Our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities on our balance sheets, changed during the three months and six months ended December 31, 2009 as follows:

(In millions)	Three Months Ended December 31, 2009	Six Months Ended December 31, 2009
Balance, beginning of period	**$ 289**	**$ 342**
Accrual for warranties issued	**61**	**94**
Adjustments to pre-existing warranties	**(2)**	**(2)**
Settlements of warranty claims	**(40)**	**(126)**
Balance, end of period	**$ 308**	**$ 308**

NOTE 15 CONTINGENCIES

Government Competition Law Matters

In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were not reasonable. Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision

and that no further penalty should accrue after that date. On February 27, 2008, the Commission issued a fine of $1.4 billion (899 million) relating to the period prior to October 22, 2007. In May 2008, we filed an application with the European Court of First Instance to annul the February 2008 fine. We paid the $1.4 billion (899 million) fine in June 2008, pending the outcome of the appeal.

On December 16, 2009, the European Commission announced that it had adopted a decision that renders legally binding commitments offered by Microsoft to address the Commission s concerns regarding competition in Web browsing software. This decision ends the Commission s investigation. It does not address whether a violation of European Commission competition law occurred. The commitments offered by Microsoft broadly ensure that computer manufacturers will remain free to install any browser on the PCs they ship, and they provide for a Web browser choice screen to be offered to end users throughout Europe. The Commission had opened its investigation in January 2008 following a complaint filed with the Commission by Opera Software ASA.

Table of Contents

PART I

Item 1

In January 2008, the Commission also opened a competition law investigation that relates primarily to interoperability with respect to our Microsoft Office family of products. This investigation resulted from complaints filed with the Commission by a trade association of Microsoft s competitors. Microsoft has made a number of proposals to address the Commission s competition law concerns in this area. The Commission announced on December 16, 2009 that it welcomed these proposals and that it will take them into account in assessing this matter.

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

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

Antitrust, Unfair Competition, and Overcharge Class Actions

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

Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers.

The settlements in all states have received final court approval. Cases in Canada have not been settled. We estimate the total cost to resolve all of the overcharge class action cases will range between $1.8 billion and $2.0 billion. The actual cost depends on factors such as the claim rate, the quantity and mix of products for which claims are made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims. At December 31, 2009, we have recorded a liability related to these claims of approximately $700 million, which reflects our estimated exposure of $1.8 billion less payments made to date of approximately $1.1 billion mostly for vouchers, legal fees, and administrative expenses.

Other Antitrust Litigation and Claims

In November 2004, Novell, Inc. filed a complaint in U.S. District Court for the District of Utah, asserting antitrust and unfair competition claims against us related to Novell s ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. This case was transferred to the District of Maryland. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. Both parties appealed, and in October 2007, the court of appeals affirmed the decision of the trial court, and remanded the case to that court for further proceedings. Summary judgment motions were filed in October 2009, and will be heard in March 2010. If any claims survive those motions, the case will be transferred back to Utah for trial.

Patent and Intellectual Property Claims

In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents (although this action began before the merger of Alcatel and Lucent in 2006, for simplicity we refer to the post-merger entity of Alcatel-Lucent). In April 2008, a jury returned a verdict in Alcatel-Lucent s favor in a trial on a consolidated group of one video and three user interface patents. The jury concluded that we had infringed two user interface patents and awarded $367 million in damages. In June 2008, the trial judge increased the amount of damages to $512 million to include $145 million of interest. We appealed that award to the Federal Circuit. In December 2008, we entered into a settlement agreement resolving all other litigation pending between Microsoft and Alcatel-Lucent, leaving

approximately $500 million remaining in dispute. In April 2009, the

Table of Contents

PART I

Item 1

U.S. Patent and Trademark Office, after a reexamination of the remaining patent in dispute, determined that the patent was invalid and Alcatel-Lucent has appealed that ruling. On September 11, 2009, the United States Court of Appeals for the Federal Circuit affirmed the liability award but vacated the verdict and remanded the case to the trial court for a re-trial of the damages ruling, indicating the damages previously awarded were too high.

In October 2003, Uniloc USA Inc., a subsidiary of a Singapore-based security technology company, filed a patent infringement suit in U.S. District Court in Rhode Island, claiming that product activation technology in Windows XP and certain other Microsoft programs violated a Uniloc patent. After we obtained a favorable summary judgment that we did not infringe any of the claims of this patent, the court of appeals vacated the trial court decision and remanded the case for trial. In April 2009, the jury returned a $388 million verdict against us, including a finding of willful infringement. On September 29, 2009, the district court judge overturned the jury verdict, ruling that the evidence did not support the jury s finding that Microsoft infringed the patent. Uniloc has appealed.

In March 2007, i4i Limited Partnership sued Microsoft in U.S. District Court in Texas claiming that certain custom XML technology in Word 2003 and 2007 infringed i4i s patent. In May 2009, a jury returned a verdict against us, finding damages of $200 million and that we willfully infringed the patent. In August 2009, the court denied our post-trial motions and awarded enhanced damages of $40 million and prejudgment interest of $37 million. The court also issued a permanent injunction prohibiting additional distribution of the allegedly infringing technology. We appealed and the appellate court stayed the injunction pending our appeal. On December 22, 2009, the court of appeals rejected our appeal and affirmed the trial court s judgment and injunction, except that the court of appeals modified the effective date of the injunction to January 11, 2010. We are seeking a rehearing before the court of appeals.

There are over 50 other patent infringement cases pending against Microsoft, 10 of which are set for trial in fiscal year 2010. These cases include a lawsuit filed against Microsoft by VirnetX Inc. in U.S. District Court in Texas in which VirnetX asserts that various Microsoft products including Windows client and server operating systems software and communications software infringe patents relating to certain secure Internet communications. Trial is scheduled for March 2010.

Other

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

As of December 31, 2009, we had accrued aggregate liabilities of approximately $900 million in other current liabilities and approximately $400 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could be up to $1.0 billion in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.

NOTE 16 EMPLOYEE SEVERANCE

In January 2009, we announced and implemented a resource management program to reduce discretionary operating expenses, employee headcount, and capital expenditures. As part of this program, we announced the elimination of 5,000 positions in research and development, marketing, sales, finance, legal, human resources, and information technology by June 30, 2010. As of September 30, 2009, we had reduced our overall number of positions by approximately 5,000 and headcount by approximately 4,600.

In November 2009, we identified an additional 800 positions for elimination based on our efforts to manage our expenses. Severance expense of approximately $52 million associated with these additional eliminations was reflected in our second quarter financial statements. To date, we have had a headcount reduction of approximately 5,300 under our resource management efforts.

Table of Contents

PART I

Item 1

The changes in our employee severance liabilities related to our resource management efforts during the three months and six months ended December 31, 2009 were as follows:

(In millions)	Three Months Ended December 31,	Six Months Ended December 31,
	2009	2009
Balance, beginning of period	$ 42	$ 127
Additional accruals	52	52
Adjustments	7	7
Cash payments	(70)	(155)
Balance, end of period	$ 31	$ 31

NOTE 17 STOCKHOLDERS EQUITY

Share Repurchases

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Shares of common stock repurchased	125	94	183	318
Value of common stock repurchased	$ 3,583	$ 2,234	$ 5,028	$ 8,200

We repurchased all shares with cash resources. As of December 31, 2009, approximately $29.5 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

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

Declaration Date	Per Share Dividend	Record Date	Total Amount	Payment Date
			(in millions)	

Fiscal year 2010					
September 18, 2009	$ 0.13	November 19, 2009	$ 1,152	December 10, 2009
December 9, 2009	$ 0.13	February 18, 2010	$ 1,145	March 11, 2010
Fiscal year 2009					
September 19, 2008	$ 0.13	November 20, 2008	$ 1,157	December 11, 2008
December 10, 2008	$ 0.13	February 19, 2009	$ 1,155	March 12, 2009

The estimate of the amount to be paid as a result of the December 9, 2009 declaration was included in other current liabilities as of December 31, 2009.

NOTE 18 SEGMENT INFORMATION

In its operation of the business, management reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. Our five segments are: Windows & Windows Live Division; Server and Tools; Online Services Division; Microsoft Business Division; and Entertainment and Devices Division. We have recast certain prior period amounts within this note to conform to the way we internally managed and monitored segment performance during the current fiscal year, including moving Windows Live from Online Services Division to Windows & Windows Live Division, Mobile Services from Online Services Division to Entertainment and Devices Division, and Razorfish from Online Services Division to Corporate. Razorfish was disposed of during the second quarter of fiscal year 2010.

Table of Contents

PART I

Item 1

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	**2008**	**2009**	**2008**
Revenue				
Windows & Windows Live Division	**$ 5,073**	$ 3,930	**$ 9,058**	$ 8,041
Server and Tools	**3,848**	3,775	**7,285**	7,214
Online Services Division	**581**	595	**1,067**	1,108
Microsoft Business Division	**4,749**	4,893	**9,155**	9,810
Entertainment and Devices Division	**2,938**	3,256	**4,829**	5,149
Unallocated and other	**1,833**	180	**548**	368
Consolidated	**$ 19,022**	$ 16,629	**$ 31,942**	$ 31,690
Operating income (loss)				
Windows & Windows Live Division	**$ 3,516**	$ 2,550	**$ 6,324**	$ 5,409
Server and Tools	**1,370**	1,336	**2,606**	2,336
Online Services Division	**(478)**	(378)	**(972)**	(704)
Microsoft Business Division	**2,914**	2,991	**5,747**	6,096
Entertainment and Devices Division	**361**	103	**654**	237
Reconciling amounts	**830**	(663)	**(1,364)**	(1,436)
Consolidated	**$ 8,513**	$ 5,939	**$ 12,995**	$ 11,938

Because of our integrated business structure, operating costs included in one segment may benefit other segments, and therefore these segments are not designed to measure operating income or loss directly related to the products included in each segment. Inter-segment cost commissions are estimated by management and used to compensate or charge each segment for such shared costs and to incent shared efforts. Management will continually evaluate the alignment of product development organizations, sales organizations, and inter-segment commissions for segment reporting purposes, which may result in changes to segment allocations in future periods.

Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each segment and it is impracticable for us to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

Reconciling amounts include adjustments to conform with U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, and accelerated depreciation and amortization of stock-based awards. In addition, certain revenue and expenses are excluded from segments or included in corporate-level activity, including certain legal settlements, accruals for legal contingencies, and accruals for employee severance. For the three months ended December 31, 2009, reconciling amounts include the recognition of previously deferred revenue related to sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost and sales of Windows 7 to original equipment manufacturers and retailers before general availability.

Table of Contents

PART I

Item 1

Significant reconciling items were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	**2008**	**2009**	**2008**
Corporate-level activity [1]	**$ (1,291)**	$ (979)	**$ (2,229)**	$ (2,086)
Stock-based compensation	**109**	191	**229**	371
Revenue reconciling amounts	**1,787**	116	**421**	303
Other	**225**	9	**215**	(24)
Total	**$ 830**	$ (663)	**$ (1,364)**	$ (1,436)

(1) *Corporate-level activity excludes stock-based compensation and revenue reconciling amounts presented separately in those line items.*

Table of Contents

PART I

Item 1

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation) as of December 31, 2009, and the related consolidated statements of income, stockholders equity, and cash flows for the three-month and six-month periods ended December 31, 2009 and 2008. These interim financial statements are the responsibility of the Corporation s management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2009, and the related consolidated statements of income, stockholders equity, and cash flows for the year then ended (not presented herein); and in our report dated July 29, 2009 we expressed an unqualified opinion on those consolidated financial statements (which report includes an explanatory paragraph regarding the adoption of new accounting standards). In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2009 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Seattle, Washington
January 28, 2010

Table of Contents

PART I

Item 2

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

Note About Forward-Looking Statements

Certain statements in Management s Discussion and Analysis (MD&A), other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, plan, may, should, will, would, will be result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties, which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled Risk Factors (refer to Part II, Item 1A). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

OVERVIEW

Management s discussion and analysis is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended June 30, 2009 and the Consolidated Financial Statements and accompanying notes (Notes) included in this Form 10-Q.

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

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated approximately 40% of its yearly segment revenues in our second fiscal quarter. In addition, quarterly revenues may be impacted by the deferral of revenue. See the discussion below regarding the deferral of revenue related to Windows 7, which negatively impacted revenue for the first quarter of fiscal year 2010 and positively impacted revenue for the second quarter of fiscal year 2010.

All growth and percentage comparisons refer to the three months and six months ended December 31, 2009, as compared with the three months and six months ended December 31, 2008, unless otherwise noted.

Summary

(In millions, except per share amounts and percentages)

	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Revenue	**$ 19,022**	$ 16,629	14%	**$ 31,942**	$ 31,690	1%
Operating income	**$ 8,513**	$ 5,939	43%	**$ 12,995**	$ 11,938	9%
Diluted earnings per share	**$ 0.74**	$ 0.47	57%	**$ 1.14**	$ 0.94	21%

Table of Contents

PART I

Item 2

Three months ended December 31, 2009 compared with three months ended December 31, 2008

Revenue increased mainly due to the launch of Windows 7 on October 22, 2009. Operating income increased reflecting increased revenue and decreased operating expenses in most categories.

- Cost of revenue decreased $279 million or 7%, primarily reflecting decreased Xbox 360 console costs and cost controls, offset in part by increased online costs, mainly traffic acquisition costs.

- Research and development expenses decreased $211 million or 9%, primarily reflecting a decrease in third-party development and programming costs, a decrease in headcount, and the capitalization of certain software development costs.

- General and administrative expenses increased $293 million or 35%, primarily due to increased legal charges.

Diluted earnings per share increased primarily reflecting increased net income and share repurchases during the past 12 months. We repurchased 183 million shares during the 12 months ended December 31, 2009.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

Revenue increased mainly due to the launch of Windows 7 on October 22, 2009. Operating income increased reflecting increased revenue and decreased operating expenses in most categories.

- Research and development expenses decreased $429 million or 9%, primarily reflecting a decrease in third-party development and programming costs, a decrease in headcount, and the capitalization of certain software development costs.

- Sales and marketing expenses decreased $297 million or 4%, due mainly to cost controls and decreased corporate marketing and advertising spending.

- Cost of revenue decreased $285 million or 4%, primarily reflecting decreased Xbox 360 console costs and cost controls, offset in part by increased online costs, mainly traffic acquisition costs.

- General and administrative expenses increased $147 million or 9%, primarily due to increased legal charges, offset in part by cost controls.

Diluted earnings per share increased primarily reflecting increased net income and share repurchases during the past 12 months.

Demand for our software, services, hardware, and online offerings has a strong correlation to global macroeconomic factors. While we see the potential for improvement in calendar year 2010, the timing is uncertain. In the meantime, we are positive about our relative market position and our product delivery plans. In addition, we remain focused on executing in the areas we can control by continuing to provide high value products at the lowest total cost of ownership while managing our expenses.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the United States of America (U.S. GAAP) and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 18 Segment Information of the Notes to Financial Statements (Part I, Item I) is presented on a basis consistent with our current internal management reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. We have recast certain prior period amounts within this section to conform to the way we internally managed and monitored segment performance during fiscal year 2010, including moving Windows Live from Online Services Division to Windows & Windows Live Division, Mobile Services from Online Services Division to Entertainment and Devices Division, and Razorfish from Online Services Division to Corporate. Razorfish was disposed of in the second quarter of fiscal year 2010.

Table of Contents

PART I

Item 2

Windows & Windows Live Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Revenue	**$ 6,904**	$ 4,064	70%	**$ 9,528**	$ 8,337	14%
Operating income	**$ 5,394**	$ 2,712	99%	**$ 6,854**	$ 5,761	19%

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

Windows Division revenue growth is directly impacted by growth of PC purchases from original equipment manufacturers (OEMs) that pre-install versions of Windows operating systems because the OEM channel accounts for approximately 80% of total Windows Division revenue. The remaining approximately 20% of Windows Division revenue (other revenue) is generated by commercial and retail sales of Windows and online advertising from Windows Live. In the first quarter of fiscal year 2010, we deferred revenue (the Windows 7 Deferral) associated with sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost and with sales of Windows 7 to retailers before general availability. We recognized the majority of this deferred revenue in the second quarter after launching Windows 7 on October 22, 2009.

Three months ended December 31, 2009 compared with three months ended December 31, 2008

Windows Division revenue increased due to strong sales of Windows 7 and PC market improvement. We estimate total worldwide PC shipments from all sources grew approximately 15% to 17%. OEM revenue increased $2.3 billion or 72%. Excluding $1.7 billion of revenue recognized related to the Windows 7 Deferral, OEM revenue increased $664 million or 21%, while OEM license units increased 22%. The OEM revenue increase was primarily driven by PC market growth, higher Windows attach rates across all regions, channels, and types of PCs and the restoration of normal OEM inventory levels, offset in part by PC market changes, including stronger growth of consumer PCs versus business PCs and of emerging markets versus developed markets. Other revenue increased $511 million or 60% driven primarily by strong Windows 7 retail sales.

Windows Division operating income increased as a result of increased revenue, offset in part by increased operating expenses. Cost of revenue increased $81 million or 25%, primarily driven by increased retail product costs, traffic acquisition costs and royalties. Sales and marketing expenses increased $113 million or 18% reflecting increased advertising and marketing campaigns for the launch of Windows 7.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

Windows Division revenue increased primarily as a result of strong sales of Windows 7 and PC market improvement. We estimate total worldwide PC shipments from all sources grew approximately 8% to 10%. OEM revenue increased $708 million or 11%. Excluding the recognition of $248 million of revenue associated with the Windows 7 Deferral, OEM revenue increased $460 million or 7%, while OEM license units increased 14%. The OEM revenue increase was primarily driven by PC market growth, higher Windows attach rates across all regions, channels, and types of PCs and the restoration of normal OEM inventory levels, offset in part by PC market changes, including stronger growth of consumer PCs versus business PCs and of emerging markets versus developed markets. Other revenue increased $483 million or 29%

driven primarily by strong Windows 7 retail sales.

Table of Contents

PART I

Item 2

Windows Division operating income increased as a result of increased revenue, offset in part by increased operating expenses. Cost of revenue increased $122 million or 19%, primarily driven by increased retail product costs, traffic acquisition costs, and royalties. Research and development expenses decreased $76 million or 11%, primarily as a result of capitalization of certain software development costs and completion of Windows 7 product development. Sales and marketing expenses increased $74 million or 6%.

Server and Tools

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Revenue	**$ 3,844**	$ 3,755	2%	**$ 7,278**	$ 7,172	1%
Operating income	**$ 1,491**	$ 1,375	8%	**$ 2,767**	$ 2,409	15%

Server and Tools licenses products, applications, tools, content, and services that are designed to make information technology professionals and developers more productive and efficient. Server and Tools product offerings consist of server software licenses and client access licenses (CAL) for Windows Server, Microsoft SQL Server, and other server products. We also offer developer tools, training and certification. Our services offerings include Premier product support services and Microsoft Consulting Services. Server products can be run on-site, in a partner-hosted environment, or in a Microsoft-hosted environment. We use multiple channels for licensing, including pre-installed OEM versions, licenses through partners, and licenses directly to end customers. Approximately 50% of Server and Tools revenue comes from annuity volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, fully packaged product and licenses sold to OEMs, and the remainder comes from services.

Three months ended December 31, 2009 compared with three months ended December 31, 2008

Server and Tools revenue increased reflecting growth in product revenue, offset in part by a decline in services revenue. Product revenue increased $103 million or 3%, primarily driven by growth in Windows Server, Enterprise CAL Suites and System Center revenue. The growth in product revenue reflects continued adoption of Windows platform applications. Services revenue declined $14 million or 2%, primarily due to decreased revenue from consulting services.

Server and Tools operating income increased primarily due to product revenue growth and a decrease in research and development expenses. Research and development expenses decreased $41 million or 7%, primarily driven by decreased headcount-related expenses and third-party development and programming costs.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

Server and Tools revenue increased reflecting growth in product revenue, offset in part by a decline in services revenue. Product revenue increased $138 million or 2%, primarily driven by growth in Enterprise CAL Suites, System Center and SQL Server revenue. The growth in product revenue reflects increased revenue from annuity volume licensing agreements and continued adoption of Windows platform applications. Services revenue declined $32 million or 2%, primarily due to decreased revenue from consulting services.

Server and Tools operating income increased primarily due to product revenue growth and decreases in all operating expense categories. Sales and marketing expenses decreased $87 million or 4%, primarily due to a decrease in headcount-related expenses and corporate marketing expenses. Research and development expenses decreased $70 million or 6%, primarily driven by reduced third-party development and programming costs and headcount-related expenses. Cost of revenue decreased $66 million or 5%, reflecting the decline in demand for

consulting services. General and administrative expenses decreased $27 million or 14%, due to decreased headcount-related expenses.

Table of Contents

PART I

Item 2

Online Services Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Revenue	**$ 581**	$ 609	(5)%	**$ 1,067**	$ 1,132	(6)%
Operating loss	**$ (466)**	$ (320)	(46)%	**$ (950)**	$ (635)	(50)%

Online Services Division (OSD) consists of an online advertising platform with offerings for both publishers and advertisers, online information offerings, such as Bing, and the MSN portals and channels around the world. We earn revenue primarily from online advertising, including search, display, and advertiser and publisher tools. Revenue is also generated through subscriptions and transactions generated from online paid services and from MSN narrowband Internet access subscribers (Access).

Three months ended December 31, 2009 compared with three months ended December 31, 2008

OSD revenue decreased as a result of lower Access and online advertising revenue. Access revenue decreased $14 million or 29%, reflecting continued migration of subscribers to broadband or other competitively-priced service providers. Online advertising revenue decreased $11 million or 2%, to $516 million, reflecting a decrease in display advertising and advertiser and publisher tools revenue, offset in part by an increase in search revenue. Foreign currency exchange rates accounted for a $13 million or two percentage point increase in revenue.

OSD operating loss increased mainly due to increased cost of revenue and decreased revenue, offset in part by decreased research and development expenses. Cost of revenue increased $171 million or 50%, primarily driven by higher online traffic acquisition costs. Research and development expenses decreased $49 million or 17%, primarily due to decreased third-party development and programming costs and headcount-related expenses.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

OSD revenue decreased primarily as a result of lower online advertising and Access revenue. Online advertising revenue decreased $32 million or 3%, to $934 million, primarily reflecting a decrease in display advertising and advertiser and publisher tools revenue. Access revenue decreased $28 million or 29%, reflecting continued migration of subscribers to broadband or other competitively-priced service providers.

OSD operating loss increased mainly due to increased cost of revenue and decreased revenue, offset in part by decreased research and development expenses. Cost of revenue increased $347 million or 54%, primarily driven by higher online traffic acquisition costs. Research and development expenses decreased $88 million or 16%, primarily due to decreased third-party development and programming costs.

Yahoo! Commercial Agreement

On December 4, 2009, we entered into a definitive 10-year agreement with Yahoo! Inc. (Yahoo) whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo websites. We believe this agreement will allow us over time to improve the effectiveness and increase the value of our search offering through greater scale in search queries and an expanded and more competitive search and advertising marketplace. The transaction is subject to regulatory review; we expect to close the transaction in fiscal year 2010.

Microsoft Business Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	**2008**		**2009**	**2008**	
Revenue	**$ 4,745**	$ 4,881	(3)%	**$ 9,149**	$ 9,835	(7)%
Operating income	**$ 3,010**	$ 3,021	%	**$ 5,867**	$ 6,199	(5)%

Table of Contents

PART I

Item 2

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

Three months ended December 31, 2009 compared with three months ended December 31, 2008

MBD revenue decreased reflecting decreased business revenue partially offset by increased consumer revenue. Business revenue decreased $231 million or 6%, primarily reflecting a decline in licensing the 2007 Microsoft Office system to transactional business customers, offset in part by a 1% increase in Microsoft Dynamics revenue. Consumer revenue increased $95 million or 12%, primarily as a result of growth in the PC market.

MBD operating income was flat reflecting decreased revenue, offset by decreased sales and marketing and research and development expenses. Sales and marketing expenses decreased $81 million or 7%, primarily driven by a decrease in corporate marketing activities and headcount-related costs associated with our corporate sales force. Research and development expenses decreased $64 million or 15%, primarily as a result of capitalization of certain Microsoft Office system software development costs.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

MBD revenue decreased reflecting decreased business and consumer revenue. Business revenue decreased $392 million or 5%, primarily reflecting a decline in licensing the 2007 Microsoft Office system to transactional business customers and a 2% decrease in Microsoft Dynamics revenue, offset in part by growth in multi-year volume licensing agreement revenue. The growth in multi-year volume licensing agreement revenue primarily reflects recognition of deferred revenue from previously signed agreements. Consumer revenue decreased $295 million or 15%, primarily as a result of pricing promotions in the first half of fiscal year 2009 that drove increased licensing in that period, a shift to lower-priced products, and a decline in licensing the 2007 Microsoft Office system.

MBD operating income decreased due mainly to decreased revenue, offset in part by decreased sales and marketing and research and development expenses. Sales and marketing expenses decreased $262 million or 12%, primarily driven by a decrease in corporate marketing activities and headcount-related costs associated with our corporate sales force. Research and development expenses decreased $95 million or 11%, primarily as a result of capitalization of certain Microsoft Office system software development costs and lower headcount-related expenses.

Entertainment and Devices Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Revenue	**$ 2,902**	$ 3,256	(11)%	**$ 4,793**	$ 5,149	(7)%
Operating income	**$ 375**	$ 130	188 %	**$ 686**	$ 290	137 %

Entertainment and Devices Division (EDD) offerings include the Xbox 360 platform (which includes the Microsoft Xbox 360 video game console system, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories), the Zune digital music and entertainment platform (including Zune HD, which was released in September 2009), PC software games, online games and services, Mediaroom (our Internet protocol television

software), the Microsoft Surface computing platform, Windows Mobile and embedded device platforms, and other devices. EDD leads the development efforts for our line of consumer software and hardware products including application software for Apple s Macintosh computers and Microsoft PC hardware products, and is responsible for all retail sales and marketing for Microsoft Office and Windows operating systems.

Table of Contents

PART I

Item 2

Three months ended December 31, 2009 compared with three months ended December 31, 2008

EDD revenue decreased reflecting a $295 million or 12% decline in Xbox 360 platform and PC game revenue. This decrease was due mainly to decreased revenue from Xbox 360 video games, decreased Xbox 360 consoles sold, and decreased revenue per console, offset in part by increased Xbox LIVE revenue. The decreased revenue from Xbox 360 video games was due primarily to the release of two significant games in the second quarter of the prior year. We shipped 5.2 million Xbox 360 consoles during the second quarter of fiscal year 2010, compared with 6.0 million Xbox 360 consoles during the second quarter of fiscal year 2009. The decreased revenue per console resulted from price reductions during the past 12 months. Non-gaming revenue decreased $59 million or 8%, primarily reflecting decreased sales of Zune digital music and entertainment devices and Windows Mobile device platforms. Foreign currency exchange rates accounted for a $49 million or two percentage point increase in revenue.

EDD operating income increased due to reduced operating expenses. Cost of revenue decreased $478 million or 23%, primarily due to lower Xbox 360 console costs, offset in part by increased royalties to partners related to increased Xbox LIVE transactions. Sales and marketing expenses decreased $75 million or 15%, primarily due to decreased marketing for the Xbox 360 platform. Research and development expenses decreased $50 million or 10%, primarily reflecting decreased headcount-related expenses and third-party development and programming costs.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

EDD revenue decreased reflecting decreases in Xbox 360 platform and PC game revenue, as well as decreased revenue from the non-gaming portion of the business. Xbox 360 platform and PC game revenue decreased by $199 million or 5% due mainly to decreased Xbox 360 consoles sold, decreased revenue per console, and decreased revenue from Xbox 360 games, offset in part by increased Xbox LIVE revenue. We shipped 7.3 million Xbox 360 consoles during the first half of fiscal year 2010, compared with 8.3 million Xbox 360 consoles during the first half of fiscal year 2009. The decreased revenue per console resulted from price reductions during the past 12 months. The decreased revenue from Xbox 360 video games was due primarily to the release of two significant games in the second quarter of the prior year. Non-gaming revenue decreased $157 million or 11%, primarily reflecting decreased sales of Zune digital music and entertainment devices and Window Mobile device platforms.

EDD operating income increased due to reduced operating expenses. Cost of revenue decreased $581 million or 19%, primarily due to lower Xbox 360 console costs, offset in part by increased royalties to partners related to increased Xbox LIVE transactions. Sales and marketing expenses decreased by $59 million or 8%, primarily due to decreased marketing for the Xbox 360 platform. Research and development expenses decreased $113 million or 12%, primarily reflecting decreased headcount-related expenses and third-party development and programming costs.

Corporate-Level Activity

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Corporate-level activity	**$ (1,291)**	$ (979)	(32)%	**$ (2,229)**	$ (2,086)	(7)%

Certain corporate-level activity is not allocated to our segments. Those results include expenses such as broad-based sales and marketing, product support services, human resources, legal, finance, information technology, corporate development and procurement activities, research and development and other costs, and legal settlements and contingencies. Corporate-level expenses increased, primarily reflecting an increase in legal charges, offset in part by cost controls and for the six months ended December 31, 2009, by decreased partner payments. Legal charges were approximately $290 million during the three months ended December 31, 2009.

Table of Contents

PART I

Item 2

OPERATING EXPENSES

Cost of Revenue

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	**2008**		**2009**	**2008**	
Cost of revenue	**$ 3,628**	$ 3,907	(7)%	**$ 6,470**	$ 6,755	(4)%
As a percent of revenue	**19%**	23%	(4)ppt	**20%**	21%	(1)ppt

Cost of revenue includes manufacturing and distribution costs for products sold and programs licensed, operating costs related to product support service centers and product distribution centers, costs incurred to drive traffic to our websites and/or acquire online advertising space (traffic acquisition costs), costs incurred to support and maintain Internet-based products and services, warranty costs, inventory valuation adjustments, costs associated with the delivery of consulting services, and the amortization of capitalized research and development costs associated with software products that have reached technological feasibility. Cost of revenue decreased reflecting decreased Xbox 360 platform costs and cost controls, offset in part by increased online costs, including traffic acquisition costs.

Research and Development

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	**2008**		**2009**	**2008**	
Research and development	**$ 2,079**	$ 2,290	(9)%	**$ 4,144**	$ 4,573	(9)%
As a percent of revenue	**11%**	14%	(3)ppt	**13%**	14%	(1)ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, the amortization of purchased software code and services content, and in-process research and development. The decrease in research and development expenses during the three months and six months ended December 31, 2009 was primarily driven by a decrease in third-party development and programming costs, a 3% reduction in headcount-related expenses, and the capitalization of certain software development costs.

Sales and Marketing

(In millions, except percentages)	Three Months Ended December 31,	Percentage Change	Six Months Ended December 31,	Percentage Change

	2009	2008		2009	2008	
Sales and marketing	**$ 3,619**	$ 3,662	(1)%	**$ 6,409**	$ 6,706	(4)%
As a percent of revenue	**19%**	22%	(3)ppt	**20%**	21%	(1)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses decreased primarily as a result of decreased corporate marketing and advertising campaigns, and for the six months ended December 31, 2009, a 3% reduction in headcount-related expenses.

Table of Contents

PART I

Item 2

General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
General and administrative	**$ 1,124**	$ 831	35%	**$ 1,865**	$ 1,718	9%
As a percent of revenue	**6%**	5%	1ppt	**6%**	5%	1ppt

General and administrative expenses include payroll, employee benefits, stock-based compensation expense and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative headcount, and legal and other administrative fees. General and administrative expenses increased during the three months and six months ended December 31, 2009 primarily driven by increased legal charges, offset in part by an 8% decrease in headcount-related expenses for the six months ended December 31, 2009.

OTHER INCOME (EXPENSE) AND INCOME TAXES

Other Income (Expense)

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

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2009	2008		2009	2008	
Dividends and interest	**$ 159**	$ 175	(9)%	**$ 324**	$ 382	(15)%
Net recognized gains on investments	**92**	270	(66)%	**162**	399	(59)%
Net gains (losses) on derivatives	**96**	(409)	*	**92**	(574)	*
Net gains (losses) on foreign currency remeasurements	**(23)**	(350)	(93)%	**32**	(529)	*
Other	**46**	13	254 %	**43**	13	231 %
Total	**$ 370**	$ (301)	*	**$ 653**	$ (309)	*

* *Not meaningful*

Three months ended December 31, 2009 compared with three months ended December 31, 2008

Dividends and interest decreased primarily due to increased interest expense on our long-term debt and lower interest rates on our fixed-income investments, offset in part by higher average investment portfolio balances. Net recognized gains on investments decreased primarily due to

sales of certain equity investments held in our strategic investments portfolio in the prior period, offset in part by lower other-than-temporary impairments. Other-than-temporary impairments were $6 million during the three months ended December 31, 2009, as compared with $262 million during the three months ended December 31, 2008 and decreased primarily due to improvements in market conditions. Net gains on derivatives increased across all asset classes in the current period as compared with losses in the prior period. Net losses from foreign currency remeasurements declined due to a weakening U.S. dollar. Other includes a gain on the divestiture of Razorfish.

Six months ended December 31, 2009 compared with six months ended December 31, 2008

Dividends and interest decreased primarily due to increased interest expense on our long-term debt and lower interest rates on our fixed-income investments, offset in part by higher average investment portfolio balances. Net recognized gains on investments decreased primarily due to sales of certain equity investments held in our strategic investments portfolio in the prior period, offset in part by lower other-than-temporary impairments. Other-than-temporary impairments were $24 million during the six months ended December 31, 2009, as compared with $334 million during the six months ended December 31, 2008 and decreased primarily due to improvements in market conditions. Net gains on derivatives increased across all asset classes as compared to the prior period. Net gains from foreign currency remeasurements compared to net losses in the prior period were due to a weakening U.S. dollar. Other includes a gain on the divestiture of Razorfish.

Table of Contents

PART I

Item 2

Income Taxes

Our effective tax rate was 25% for both the three months and six months ended December 31, 2009, as compared with 26% for the three months and 27% for the six months ended December 31, 2008. The fiscal year 2010 rate reflects a higher mix of foreign earnings taxed at lower rates.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $36.1 billion as of December 31, 2009, compared with $31.4 billion as of June 30, 2009. Equity and other investments were $7.0 billion as of December 31, 2009, compared with $4.9 billion as of June 30, 2009. Our investments consist primarily of fixed-income securities, diversified among industries and individual issuers. Our investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar-denominated securities, but also includes foreign currency-denominated securities in order to diversify risk. We invest primarily in short-term securities to facilitate liquidity and for capital preservation.

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine fair value. This pricing methodology applies to our Level 1 investments, such as exchange-traded mutual funds, domestic and international equities, U.S. treasuries, and agency securities. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government bonds, mortgage-backed securities, and certain agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured using unobservable inputs are an immaterial portion of our portfolio.

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

While we own certain mortgage- and asset-backed fixed-income securities, our portfolio as of December 31, 2009 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of the mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability.

Debt

In September 2008, our Board of Directors authorized debt financings of up to $6.0 billion. Our initial commercial paper program provided for the issuance and sale of up to $2.0 billion. Following the issuance of our long-term debt in May 2009, we increased the commercial paper program and issued an additional $250 million of commercial paper during the six months ended December 31, 2009. As of December 31, 2009, we had $2.25 billion of commercial paper and $3.75 billion of long-term debt issued and outstanding.

Table of Contents

PART I

Item 2

Short-term Debt

As of December 31, 2009, our $2.25 billion of commercial paper issued and outstanding had a weighted average interest rate, including issuance costs, of 0.14% and maturities of 16 to 210 days. In November 2009, we replaced our $2.0 billion and $1.0 billion credit facilities with a $2.25 billion 364-day credit facility, which expires on November 5, 2010. This facility serves as a back-up for our commercial paper program. As of December 31, 2009, we were in compliance with the financial covenant in the credit facility, which requires a coverage ratio maintained of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facilities during the six months ended December 31, 2009.

Long-term Debt

As of December 31, 2009, we had issued and outstanding $3.75 billion of debt securities as follows: $2.0 billion aggregate principal amount of 2.95% notes due 2014, $1.0 billion aggregate principal amount of 4.20% notes due 2019, and $750 million aggregate principal amount of 5.20% notes due 2039 (collectively the Notes). Interest on the Notes is payable semi-annually on June 1 and December 1 of each year to holders of record on the preceding May 15 and November 15. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

We are using the net proceeds from sales of the debt securities for general corporate purposes, which may include funding for working capital, capital expenditures, repurchases of our capital stock, and acquisitions.

Unearned Revenue

Unearned revenue at December 31, 2009 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements, paid either upfront or annually at the beginning of each billing coverage period, which are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at December 31, 2009 also included payments for: unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis for Windows XP; post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions; Microsoft Dynamics business solutions products; unspecified enhancements for Zune HD; the Windows 7 Upgrade Option program; online advertising for which the advertisement has yet to be displayed; Mediaroom; and other offerings for which we have been paid upfront and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of December 31, 2009:

(In millions)	
Three Months Ending,	
March 31, 2010	$ 4,975
June 30, 2010	3,384
September 30, 2010	1,924
December 31, 2010	1,078
Thereafter	1,167
Total	$ 12,528

See Note 13 Unearned Revenue of the Notes to Financial Statements (Part I, Item 1).

Retained Deficit

As a result of the special dividend paid in the second quarter of fiscal year 2005 and common stock repurchased, our retained deficit, including accumulated other comprehensive income, was $18.3 billion at December 31, 2009. Our retained deficit is not expected to affect our future ability to operate, pay dividends, or repay our debt given our continuing profitability and strong cash and financial position.

Table of Contents

PART I

Item 2

Cash Flows

Cash flow from operations increased $1.9 billion to $11.1 billion for the six months ended December 31, 2009. This increase was due mainly to payment of approximately $3.1 billion to the Internal Revenue Service in the prior year as a result of our settlement of the 2000-2003 audit examination, offset in part by a decrease in cash received from customers in the current year.

Cash used for financing was $6.5 billion for the six months ended December 31, 2009, a decrease of $2.6 billion from the corresponding period of the prior year. This decrease was due mainly to a $3.9 billion decrease in common stock repurchases, offset in part by a $1.7 billion decrease in net proceeds from debt and short-term borrowings.

Cash used in investing was $1.3 billion for the six months ended December 31, 2009, a decrease of $613 million from the corresponding period of the prior year. This decrease reflects lower additions to property and equipment.

Share Repurchases

During the three months and six months ended December 31, 2009, we repurchased 125 million and 183 million shares of Microsoft common stock for $3.6 billion and $5.0 billion, respectively, under the repurchase plan we announced on September 22, 2008. As of December 31, 2009, approximately $29.5 billion remained of the $40.0 billion approved repurchase amount. All repurchases were made using cash resources. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

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

Declaration Date	Per Share Dividend	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal year 2010				
September 18, 2009	$ 0.13	November 19, 2009	$ 1,152	December 10, 2009
December 9, 2009	$ 0.13	February 18, 2010	$ 1,145	March 11, 2010
Fiscal year 2009				
September 19, 2008	$ 0.13	November 20, 2008	$ 1,157	December 11, 2008
December 10, 2008	$ 0.13	February 19, 2009	$ 1,155	March 12, 2009

Other Planned Uses of Capital

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

We believe existing cash, cash equivalents and short-term investments, together with funds generated from operations, should be sufficient to meet operating requirements, regular quarterly dividends, debt repayment schedules, and share repurchases. Our philosophy regarding the maintenance of a balance sheet with a large component of cash and cash equivalents, short-term investments, and equity and other investments,

reflects our views on potential future capital requirements relating to research and development, creation and expansion of sales distribution channels, investments and acquisitions, share dilution management, legal risks, and challenges to our business model. We regularly assess our investment management approach in view of our current and potential future needs.

Table of Contents

PART I

Item 2

Off-Balance Sheet Arrangements

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

RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

On July 1, 2009, we adopted guidance issued by the Financial Accounting Standards Board (FASB) on business combinations. The guidance retains the fundamental requirements that the acquisition method of accounting (previously referred to as the purchase method of accounting) be used for all business combinations, but requires a number of changes, including changes in the way assets and liabilities are recognized and measured as a result of business combinations. It also requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. We have applied this guidance to business combinations completed since July 1, 2009.

On July 1, 2009, we adopted the guidance issued by the FASB that changes the accounting and reporting for non-controlling interests. Non-controlling interests are to be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control are to be accounted for as equity transactions. In addition, net income attributable to a non-controlling interest is to be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, is to be recorded at fair value with any gain or loss recognized in net income. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2009, we adopted the guidance on fair value measurement for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Adoption of the new guidance did not have a material impact on our financial statements.

Recent Accounting Guidance Not Yet Adopted

In January 2010, the FASB issued guidance to amend the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, adoption of this new guidance will not have a material impact on our financial statements.

In October 2009, the FASB issued guidance on revenue recognition that will become effective for us beginning July 1, 2010, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe adoption of this new guidance will not have a material impact on our financial statements.

In June 2009, the FASB issued guidance on the consolidation of variable interest entities, which is effective for us beginning July 1, 2010. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. We believe adoption of this new guidance will not have a material impact on our financial statements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

Table of Contents

PART I

Item 2

Revenue Recognition

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements.

A portion of the revenue related to Windows XP is recorded as unearned due to undelivered elements including, in some cases, free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. The amount of revenue allocated to undelivered elements is based on the VSOE of fair value for those elements using the residual method or relative fair value method. Unearned revenue due to undelivered elements is recognized ratably on a straight-line basis over the related products life cycles. Revenue related to Windows Vista is not subject to a similar deferral because there are no significant undelivered elements. However, Windows Vista revenue is subject to deferral as a result of the Windows 7 Upgrade Option program which started June 26, 2009. The program allowed customers who purchased certain versions of Windows Vista to receive an upgrade to the corresponding version of Windows 7 at minimal or no cost. In addition, purchasers of retail packaged Windows Vista from participating retailers in participating markets may have qualified for a free or discounted upgrade to the equivalent Windows 7 product when the product became generally available in the second quarter of fiscal year 2010. Accordingly, previously deferred revenue related to the undelivered Windows 7 product sold was recognized in the second quarter of fiscal year 2010 once the product had been delivered.

Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product s estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

Impairment of Investment Securities

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

Goodwill

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

Table of Contents

PART I

Item 2

In connection with the disposal of Razorfish, we performed an interim impairment analysis of our Online Services Division goodwill balance during the first quarter of fiscal year 2010. No impairment of goodwill was identified.

Research and Development Costs

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

Legal and Other Contingencies

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

Income Taxes

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

Stock-Based Compensation

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

Product Warranties

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

Table of Contents

PART I

Item 3

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

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

Foreign Currency

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

Interest Rate

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

Equity

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

Commodity

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

VALUE-AT-RISK

We use a value-at-risk (VaR) model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in the fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model is not intended to represent actual losses in fair value, including determinations of other-than-temporary losses in fair value in accordance with U.S. GAAP, but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

Table of Contents

PART I,II

Item 3,4,1

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 as of December 31, 2009 and June 30, 2009 and for the three months ended December 31, 2009:

(In millions)

			Three Months Ended December 31,		
	December 31, 2009	June 30, 2009	2009		
Risk Categories			**Average**	**High**	**Low**
Foreign currency	**$ 37**	$ 68	**$ 50**	**$ 67**	**$ 37**
Interest rate	**$ 49**	$ 42	**$ 48**	**$ 51**	**$ 45**
Equity	**$ 194**	$ 157	**$ 186**	**$ 194**	**$ 172**
Commodity	**$ 19**	$ 16	**$ 17**	**$ 19**	**$ 15**

Total one-day VaR for the combined risk categories was $228 million at December 31, 2009 and $211 million at June 30, 2009. The total VaR is 24% less at December 31, 2009, and 25% less at June 30, 2009, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On December 16, 2009, the European Commission announced it had adopted a decision that makes legally binding commitments offered by Microsoft to address the Commission s concerns regarding competition in Web browsing software. This decision ends the Commission s investigation. It does not address whether a violation of European Commission competition law occurred. The commitments we offered broadly ensure that computer manufacturers will remain free to install any browser on the PCs they ship, and they provide for a Web browser choice screen to be offered to end users throughout Europe. The Commission had opened its investigation in January 2008 following a complaint filed with the Commission by Opera Software ASA.

In January 2008, the Commission also opened a competition law investigation that relates primarily to interoperability with respect to our Microsoft Office family of products. This investigation resulted from complaints filed with the Commission by a trade association of Microsoft s competitors. We made a number of proposals to address the Commission s competition law concerns. The Commission announced on

December 16, 2009 that it welcomed and would consider these proposals.

See Note 15 Contingencies of the Notes to Financial Statements (Part I, Item 1) for information regarding other legal proceedings in which we are involved.

Table of Contents

PART II

Item 1A

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.

Challenges to our business model may reduce our revenues and operating margins. Our business model has been based upon customers paying a fee to license software that we develop and distribute. Under this license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. Certain open source software business models challenge our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not bear the full costs of research and development for the software. In some cases, their products may infringe patents granted to Microsoft for our inventions. In addition, some of these products may build on Microsoft ideas that we provide to them free or at low royalties in connection with our interoperability initiatives. To the extent open source software gains increasing market acceptance, our sales, revenue, and operating margins may decline.

Another development is the business model under which companies provide software and content over the Internet in exchange for revenues primarily from advertising or subscriptions. An example of an advertising-funded business model is Internet search, where providing a robust alternative is particularly important and challenging due to the scale effects enjoyed by a single market dominant competitor. Advances in computing and communications technologies have made this model viable and enabled the rapid growth of some of our competitors. We are devoting significant resources to develop our own competing software plus services strategies. For users, this includes improvements to our Windows Live service and creation of online companion applications to certain Microsoft Office products. For developers, this includes our recent commercial release of the Windows Azure Platform, our hosted computing platform that is designed to facilitate rapid, flexible and scalable development of cloud-based services. It is uncertain whether these strategies will be successful.

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

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

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

Table of Contents

PART II

Item 1A

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

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

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

- engineering more secure products;
- enhancing security and reliability features in our products;
- helping our customers make the best use of our products and services to protect against computer viruses and other attacks;
- improving the deployment of software updates to address security vulnerabilities;
- investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed; and
- providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

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

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

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

Table of Contents

PART II

Item 1A

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

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

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

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

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

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

Our business depends on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

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

We make significant investments in new products and services that may not be profitable. Our growth depends on our ability to innovate by offering new, and adding value to our existing, software and service offerings. We will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Xbox 360, Live Search, Windows Server, Zune, Windows Live, the Windows Azure Services platform, and other software plus services offerings. 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 products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

Table of Contents

PART II

Item 1A

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

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

We may have additional tax liabilities. We are subject to income taxes in the United States and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made. In addition, there have been proposals to reform U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. We earn a substantial portion of our income in foreign countries. Although we cannot predict whether or in what form this proposed legislation will pass, if enacted it could have a material adverse impact on our tax expense and cash flow.

Our vertically-integrated hardware and software products may experience quality or supply problems. Our hardware products such as the Xbox 360 console are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We obtain some components of our hardware devices from sole suppliers. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Either component shortages or excess or obsolete inventory may require us to record charges to cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenues and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

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

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting

Table of Contents

corrupt payments. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region and difficulties in staffing and managing foreign operations may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations and our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers.

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

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

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

Table of Contents

PART II

Item 2,4

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

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

(c) STOCK REPURCHASES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares (or Approximate Dollar Value of Shares) that May Yet be Purchased under the Plans or Programs
				(in millions)
October 1, 2009 October 31, 2009	28,643,300	$ 25.62	28,643,300	$ 32,335
November 1, 2009 November 30, 2009	41,038,704	$ 29.37	41,038,704	$ 31,129
December 1, 2009 December 31, 2009	54,942,038	$ 29.92	54,942,038	$ 29,485
	124,624,042		124,624,042	

During the second quarter of fiscal year 2010, we repurchased 124.6 million shares of Microsoft common stock for $3.6 billion using cash resources. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of December 31, 2009, approximately $29.5 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Shareholders was held on November 19, 2009.

The following proposals were adopted by the margins indicated:

1. To elect a Board of Directors to hold office until the next annual meeting of shareholders and until their successors are elected and qualified.

	Number of Shares			
	For	Against	Abstain	Broker non-vote
William H. Gates III	7,552,484,807	94,511,488	9,260,956	147
Steven A. Ballmer	7,566,955,125	77,856,616	11,445,506	150

Dina Dublon	7,567,954,251	72,575,214	15,727,575	357
Raymond V. Gilmartin	7,533,959,553	105,550,574	16,746,221	1,049
Reed Hastings	7,569,376,630	70,444,899	16,435,516	353
Maria Klawe	7,571,087,643	69,093,173	16,076,234	348
David F. Marquardt	7,557,831,460	82,232,928	16,192,660	349
Charles H. Noski	7,564,445,736	75,178,398	16,632,907	357
Helmut Panke	7,566,091,453	72,672,449	17,493,146	350

2. To ratify selection of Deloitte & Touche LLP as Microsoft Corporation s independent auditor for fiscal year 2010.

For	7,564,844,143
Against	77,903,886
Abstain	13,509,349
Broker non-vote	20

Table of Contents

PART II

Item 4

3. To approve amendments to Amended and Restated Articles of Incorporation.

For	7,592,530,300
Against	40,364,220
Abstain	23,362,606
Broker non-vote	272

4. Advisory vote on Executive Compensation.

For	7,526,160,375
Against	80,999,808
Abstain	49,095,442
Broker non-vote	1,772

The following proposals were not adopted by the margins indicated:

5. Shareholder proposal to adopt healthcare reform principles.

For	192,678,109
Against	5,227,471,937
Abstain	917,923,497
Broker non-vote	1,318,183,855

6. Shareholder proposal to disclose charitable contributions.

For	247,760,136
Against	5,336,657,314
Abstain	753,651,391
Broker non-vote	1,318,188,557

Table of Contents

PART II

Item 6

ITEM 6. EXHIBITS

3.1	Amended and Restated Articles of Incorporation of Microsoft Corporation
3.2	Bylaws of Microsoft Corporation
10.20	Resignation Agreement between Christopher Liddell and Microsoft Corporation dated December 1, 2009
12	Computation of Ratio of Earnings to Fixed Charges
15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase
101.DEF**	XBRL Taxonomy Extension Definition Linkbase
101.LAB**	XBRL Taxonomy Extension Label Linkbase
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase

* *Furnished, not filed.*

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

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

Table of Contents

SIGNATURE

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

MICROSOFT CORPORATION

/s/ FRANK H. BROD
Frank H. Brod
Corporate Vice President, Finance and Administration;

Chief Accounting Officer (Duly Authorized Officer)
January 28, 2010