MICROSOFT CORP
Form 10-Q
January 30, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended December 31, 2018

OR

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

Commission File Number: 001-37845

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

(425) 882-8080

(Registrant's telephone number, including area code)

None

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

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

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

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

Class	Outstanding as of January 25, 2019
Common Stock, $0.00000625 par value per share	7,672,213,446 shares

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2018

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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,	
	2018	2017	2018	2017
Revenue:				
Product	$ 16,219	$ 17,926	$ 33,518	$ 32,224
Service and other	16,252	10,992	28,037	21,232
Total revenue	32,471	28,918	61,555	53,456
Cost of revenue:				
Product	5,885	5,498	9,534	8,478
Service and other	6,538	5,566	12,794	10,864
Total cost of revenue	12,423	11,064	22,328	19,342
Gross margin	20,048	17,854	39,227	34,114
Research and development	4,070	3,504	8,047	7,078
Sales and marketing	4,588	4,562	8,686	8,374
General and administrative	1,132	1,109	2,281	2,275
Operating income	10,258	8,679	20,213	16,387
Other income, net	127	490	393	766
Income before income taxes	10,385	9,169	20,606	17,153
Provision for income taxes	1,965	15,471	3,362	16,879
Net income (loss)	$ 8,420	$ (6,302)	$ 17,244	$ 274

Earnings (loss) per share:				
Basic	$1.09	$(0.82)	$2.24	$0.04
Diluted	$1.08	$(0.82)	$2.22	$0.04
Weighted average shares outstanding:				
Basic	7,692	7,710	7,683	7,709
Diluted	7,768	7,710	7,767	7,799

Refer to accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Net income (loss)	$ 8,420	$ (6,302)	$ 17,244	$ 274
Other comprehensive income (loss), net of tax:				
Net change related to derivatives	(15)	(7)	(60)	(113)
Net change related to investments	881	(878)	620	(1,166)
Translation adjustments and other	(264)	(40)	(319)	253
Other comprehensive income (loss)	602	(925)	241	(1,026)
Comprehensive income (loss)	$ 9,022	$ (7,227)	$ 17,485	$ (752)

Refer to accompanying notes. Refer to Note 16 – Accumulated Other Comprehensive Income (Loss) for further information.

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BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2018	June 30, 2018
Assets		
Current assets:		
Cash and cash equivalents	$6,638	$11,946
Short-term investments	121,024	121,822
Total cash, cash equivalents, and short-term investments	127,662	133,768
Accounts receivable, net of allowance for doubtful accounts of $354 and $377	19,680	26,481
Inventories	1,961	2,662
Other	7,571	6,751
Total current assets	156,874	169,662
Property and equipment, net of accumulated depreciation of $33,082 and $29,223	32,717	29,460
Operating lease right-of-use assets	6,806	6,686
Equity investments	2,274	1,862
Goodwill	41,577	35,683
Intangible assets, net	8,482	8,053
Other long-term assets	10,129	7,442
Total assets	$258,859	$258,848
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$7,563	$8,617
Current portion of long-term debt	3,516	3,998
Accrued compensation	4,624	6,103
Short-term income taxes	2,033	2,121
Short-term unearned revenue	24,285	28,905
Other	8,297	8,744

Total current liabilities	50,318	58,488
Long-term debt	69,653	72,242
Long-term income taxes	29,161	30,265
Long-term unearned revenue	3,799	3,815
Deferred income taxes	2,062	541
Operating lease liabilities	5,683	5,568
Other long-term liabilities	6,055	5,211
Total liabilities	166,731	176,130
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 7,683 and 7,677	77,556	71,223
Retained earnings	16,585	13,682
Accumulated other comprehensive loss	(2,013)	(2,187)
Total stockholders' equity	92,128	82,718
Total liabilities and stockholders' equity	$258,859	$258,848

Refer to accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Operations				
Net income (loss)	$8,420	$(6,302)	$17,244	$274
Adjustments to reconcile net income (loss) to net cash from operations:				
Depreciation, amortization, and other	2,995	2,536	5,832	5,035
Stock-based compensation expense	1,183	986	2,290	1,959
Net recognized gains on investments and derivatives	(135)	(684)	(375)	(1,207)
Deferred income taxes	(173)	(2,305)	(420)	(2,358)
Changes in operating assets and liabilities:				
Accounts receivable	(2,396)	(3,908)	6,798	4,041
Inventories	1,654	1,205	698	182
Other current assets	(173)	354	(850)	36
Other long-term assets	(473)	(344)	(452)	(622)
Accounts payable	(440)	938	(835)	531
Unearned revenue	(2,122)	(1,065)	(4,563)	(2,871)
Income taxes	(64)	15,974	(1,155)	16,635
Other current liabilities	656	643	(1,666)	(1,521)
Other long-term liabilities	(32)	(153)	11	201
Net cash from operations	8,900	7,875	22,557	20,315
Financing				
Proceeds from issuance of short-term debt, maturities of 90 days or less, net	0	3,759	0	49
Proceeds from issuance of debt	0	3,229	0	7,183
Repayments of debt	(3,000)	(3,327)	(3,000)	(4,496)
Common stock issued	200	189	560	496
Common stock repurchased	(6,413)	(2,008)	(10,157)	(4,578)
Common stock cash dividends paid	(3,544)	(3,238)	(6,764)	(6,241)
Other, net	(459)	(156)	(1,239)	(306)
Net cash used in financing	(13,216)	(1,552)	(20,600)	(7,893)

Investing				
Additions to property and equipment	(3,707)	(2,586)	(7,309)	(4,718)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(1,593)	(27)	(1,838)	(206)
Purchases of investments	(16,858)	(45,154)	(36,409)	(78,115)
Maturities of investments	3,782	6,352	8,996	11,578
Sales of investments	14,176	41,261	29,407	64,297
Securities lending payable	0	(177)	0	(71)
Net cash used in investing	(4,200)	(331)	(7,153)	(7,235)
Effect of foreign exchange rates on cash and cash equivalents	17	(17)	(112)	9
Net change in cash and cash equivalents	(8,499)	5,975	(5,308)	5,196
Cash and cash equivalents, beginning of period	15,137	6,884	11,946	7,663
Cash and cash equivalents, end of period	$6,638	$12,859	$6,638	$12,859

Refer to accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Common stock and paid-in capital				
Balance, beginning of period	$71,303	$69,419	$71,223	$69,315
Common stock issued	5,887	189	6,247	496
Common stock repurchased	(828)	(402)	(2,215)	(1,577)
Stock-based compensation expense	1,183	986	2,290	1,959
Other, net	11	0	11	(1)
Balance, end of period	77,556	70,192	77,556	70,192
Retained earnings				
Balance, beginning of period	17,279	19,702	13,682	17,769
Net income (loss)	8,420	(6,302)	17,244	274
Common stock cash dividends	(3,546)	(3,232)	(7,074)	(6,471)
Common stock repurchased	(5,568)	(1,601)	(7,944)	(3,005)
Cumulative effect of accounting changes	0	0	677	0
Balance, end of period	16,585	8,567	16,585	8,567
Accumulated other comprehensive income (loss)				
Balance, beginning of period	(2,615)	526	(2,187)	627
Other comprehensive income (loss)	602	(925)	241	(1,026)
Cumulative effect of accounting changes	0	0	(67)	0
Balance, end of period	(2,013)	(399)	(2,013)	(399)
Total stockholders' equity	$92,128	$78,360	$92,128	$78,360

Cash dividends declared per common share	$0.46	$0.42	$0.92	$0.84

Refer to accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 — ACCOUNTING POLICIES

Accounting Principles

Our unaudited interim consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair presentation of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation fiscal year 2018 Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on August 3, 2018.

We have recast certain prior period amounts related to investments, derivatives, and fair value measurements to conform to the current period presentation based on our adoption of the new accounting standard for financial instruments. We have also recast prior period commercial cloud revenue to include the commercial portion of LinkedIn to provide a comparable view of our commercial cloud business performance. The commercial portion of LinkedIn includes LinkedIn Recruiter, Sales Navigator, premium business subscriptions, and other services for organizations. The recast of these prior period amounts had no impact on our consolidated financial statements.

Principles of Consolidation

The consolidated financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated.

Estimates and Assumptions

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

Financial Instruments

Investments

We consider all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. The fair values of these investments approximate their carrying values. In general, investments with original maturities of greater than three months and remaining maturities of less than one year are classified as short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations.

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Debt investments are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in fair value, excluding other-than-temporary impairments, are recorded in other comprehensive income ("OCI"). Debt investments are impaired when a decline in fair value is judged to be other-than-temporary. Fair value is calculated based on publicly available market information or other estimates determined by management. We employ a systematic methodology on a quarterly basis 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, and the duration and extent to which the fair value is less than cost. 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. In addition, we 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 in other income (expense), net and a new cost basis in the investment is established.

Equity investments with readily determinable fair values are measured at fair value. Equity investments without readily determinable fair values are measured using the equity method, or measured at cost with adjustments for observable changes in price or impairments (referred to as the measurement alternative). We perform a qualitative assessment on a quarterly basis and recognize an impairment if there are sufficient indicators that the fair value of the investment is less than carrying value. Changes in value are recorded in other income (expense), net.

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

Derivatives

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

For derivative instruments designated as fair value hedges, gains and losses are recognized in other income (expense), net with offsetting gains and losses on the hedged items. For options designated as fair value hedges, changes in the time value are excluded from the assessment of hedge effectiveness and recognized in other income (expense), net.

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

For derivative instruments that are not designated as hedges, gains and losses from changes in fair values are primarily recognized in other income (expense), net.

Fair Value Measurements

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

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

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

We measure equity investments without readily determinable fair values on a nonrecurring basis. The fair values of these investments are determined based on valuation techniques using the best information available, and may include quoted market prices, market comparables, and discounted cash flow projections.

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

Contract Balances

As of December 31, 2018 and June 30, 2018, long-term accounts receivable, net of allowance for doubtful accounts, were $1.9 billion and $1.8 billion, respectively, and are included in other long-term assets on our consolidated balance sheets.

Recent Accounting Guidance

Recently Adopted Accounting Guidance

Income Taxes – Intra-Entity Asset Transfers

In October 2016, the Financial Accounting Standards Board ("FASB") issued new guidance requiring an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than when the asset has been sold to an outside party. We adopted the guidance effective July 1, 2018. Adoption of the guidance was applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. We recorded a net cumulative-effect adjustment that resulted in an increase in retained earnings of $557 million, which reversed the previous deferral of income tax consequences and recorded new deferred tax assets from intra-entity transfers involving assets other than inventory, partially offset by a U.S. deferred tax liability related to global intangible low-taxed income ("GILTI"). Adoption of the standard resulted in an increase in long-term deferred tax assets of $2.8 billion, an increase in long-term deferred tax liabilities of $2.1 billion, and a reduction in other current assets of $152 million. As a result of the Tax Cuts and Jobs Act ("TCJA"), we are continuing to evaluate the impact of this standard on our consolidated financial statements, including accounting

policies, processes, and systems. Adoption of the standard had no impact to cash from or used in operating, financing, or investing on our consolidated cash flows statements.

Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

In January 2016, the FASB issued a new standard related to certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the changes in the standard is the requirement for changes in the fair value of our equity investments, with certain exceptions, to be recognized through net income rather than OCI.

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We adopted the standard effective July 1, 2018. Adoption of the standard was applied using a modified retrospective approach through a cumulative-effect adjustment from accumulated other comprehensive income ("AOCI") to retained earnings as of the effective date, and we elected to measure equity investments without readily determinable fair values at cost with adjustments for observable changes in price or impairments. The cumulative-effect adjustment included any previously held unrealized gains and losses held in AOCI related to our equity investments carried at fair value as well as the impact of recording the fair value of certain equity investments carried at cost. The impact on our consolidated balance sheets upon adoption was not material. Adoption of the standard had no impact to cash from or used in operating, financing, or investing on our consolidated cash flows statements.

Recent Accounting Guidance Not Yet Adopted

Financial Instruments – Targeted Improvements to Accounting for Hedging Activities

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

Financial Instruments – Credit Losses

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

NOTE 2 — EARNINGS PER SHARE

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

The components of basic and diluted EPS were as follows:

(In millions, except per share amounts)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Net income (loss) available for common shareholders (A)	$ 8,420	$ (6,302)	$ 17,244	$ 274
Weighted average outstanding shares of common stock (B)	7,692	7,710	7,683	7,709
Dilutive effect of stock-based awards	76	0	84	90
Common stock and common stock equivalents (C)	7,768	7,710	7,767	7,799
Earnings (Loss) Per Share				
Basic (A/B)	$ 1.09	$ (0.82)	$ 2.24	$ 0.04
Diluted (A/C)	$ 1.08	$ (0.82)	$ 2.22	$ 0.04

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

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NOTE 3 — OTHER INCOME (EXPENSE), NET

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Interest and dividends income	$ 704	$ 530	$ 1,385	$ 1,003
Interest expense	(672)	(698)	(1,346)	(1,370)
Net recognized gains on investments	94	768	337	1,341
Net gains (losses) on derivatives	41	(84)	38	(134)
Net losses on foreign currency remeasurements	(74)	(60)	(69)	(69)
Other, net	34	34	48	(5)
Total	$ 127	$ 490	$ 393	$ 766

Net Recognized Gains (Losses) on Investments

Net recognized gains (losses) on debt investments were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Realized gains from sales of available-for-sale securities	$ 6	$ 5	$ 13	$ 18
Realized losses from sales of available-for-sale securities	(5)	(259)	(90)	(339)
Other-than-temporary impairments of investments	(7)	(4)	(7)	(5)

Total	$ (6)	$ (258)	$ (84)	$ (326)

Net recognized gains (losses) on equity investments were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Net realized gains on investments sold	$ 30	$ 1,046	$ 233	$ 1,692
Net unrealized gains on investments still held	73	0	191	0
Impairments of investments	(3)	(20)	(3)	(25)
Total	$ 100	$ 1,026	$ 421	$ 1,667

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NOTE 4 — INVESTMENTS

Investment Components

The components of investments were as follows:

(In millions)	Fair Value Level	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity Investments
December 31, 2018								
Changes in Fair Value Recorded in Other Comprehensive Income								
Commercial paper	Level 2	$ 1,306	$ 0	$ 0	$ 1,306	$ 1,207	$ 99	$ 0
Certificates of deposit	Level 2	1,440	0	0	1,440	1,024	416	0
U.S. government securities	Level 1	103,915	422	(707)	103,630	3	103,627	0
U.S. agency securities	Level 2	290	0	0	290	0	290	0
Foreign government bonds	Level 2	6,412	1	(11)	6,402	1,029	5,373	0
Mortgage- and asset-backed securities	Level 2	3,540	3	(15)	3,528	0	3,528	0
Corporate notes and bonds	Level 2	7,445	14	(79)	7,380	15	7,365	0
Corporate notes and bonds	Level 3	15	0	0	15	0	15	0
Municipal securities	Level 2	268	35	(1)	302	0	302	0
Total debt investments		$ 124,631	$ 475	$ (813)	$ 124,293	$ 3,278	$ 121,015	$ 0
Changes in Fair Value Recorded in Net Income								
Equity investments	Level 1				$ 584	$ 321	$ 20	$ 243
Equity investments	Other				2,031	0	0	2,031

Total equity investments	$2,615	$ 321	$ 20	$ 2,274
Cash	$3,039	$ 3,039	$ 0	$ 0
Derivatives, net [a]	(11)	0	(11)	0
Total	$129,936	$ 6,638	$ 121,024	$ 2,274

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(In millions)	Fair Value Level	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity Investments
June 30, 2018								
Changes in Fair Value Recorded in								
Other Comprehensive Income								
Commercial paper	Level 2	$2,513	$ 0	$0	$2,513	$ 2,215	$ 298	$ 0
Certificates of deposit	Level 2	2,058	0	0	2,058	1,865	193	0
U.S. government securities	Level 1	108,120	62	(1,167)	107,015	2,280	104,735	0
U.S. agency securities	Level 2	1,742	0	0	1,742	1,398	344	0
Foreign government bonds	Level 1	22	0	0	22	0	22	0
Foreign government bonds	Level 2	5,063	1	(10)	5,054	0	5,054	0
Mortgage- and asset-backed securities	Level 2	3,864	4	(13)	3,855	0	3,855	0
Corporate notes and bonds	Level 2	6,929	21	(56)	6,894	0	6,894	0
Corporate notes and bonds	Level 3	15	0	0	15	0	15	0
Municipal securities	Level 2	271	37	(1)	307	0	307	0
Total debt investments		$130,597	$ 125	$(1,247)	$129,475	$ 7,758	$ 121,717	$ 0
Equity investments	Level 1				$533	$ 246	$ 0	$ 287
Equity investments	Level 3				18	0	0	18
Equity investments	Other				1,558	0	1	1,557
Total equity investments					$2,109	$ 246	$ 1	$ 1,862
Cash					$3,942	$ 3,942	$ 0	$ 0
Derivatives, net [a]					104	0	104	0
Total					$135,630	$ 11,946	$ 121,822	$ 1,862

(a) Refer to Note 5 – Derivatives for further information on the fair value of our derivative instruments.
Equity investments presented as "Other" in the tables above include investments without readily determinable fair values measured using the equity method or measured at cost with adjustments for observable changes in price or impairments, and investments measured at fair value using net asset value as a practical expedient which are not categorized in the fair value hierarchy. As of December 31, 2018 and June 30, 2018, equity investments without readily determinable fair values measured at cost with adjustments for observable changes in price or impairments were $1.1 billion and $697 million, respectively.

As of December 31, 2018, we had no collateral received under agreements for loaned securities. As of June 30, 2018, collateral received under agreements for loaned securities was $1.8 billion and primarily comprised U.S. government and agency securities.

Unrealized Losses on Debt Investments

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

	Less than 12 Months		12 Months or Greater			
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
December 31, 2018						
U.S. government and agency securities	$16,776	$(93)	$52,757	$(614)	$69,533	$(707)
Foreign government bonds	51	(4)	87	(7)	138	(11)
Mortgage- and asset-backed securities	1,825	(8)	359	(7)	2,184	(15)
Corporate notes and bonds	4,372	(53)	770	(26)	5,142	(79)
Municipal securities	29	(1)	13	0	42	(1)
Total	$23,053	$ (159)	$ 53,986	$ (654)	$ 77,039	$ (813)

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	Less than 12 Months		12 Months or Greater			
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2018						
U.S. government and agency securities	$82,352	$(1,064)	$4,459	$(103)	$86,811	$(1,167)
Foreign government bonds	3,457	(7)	13	(3)	3,470	(10)
Mortgage- and asset-backed securities	2,072	(9)	96	(4)	2,168	(13)
Corporate notes and bonds	3,111	(43)	301	(13)	3,412	(56)
Municipal securities	45	(1)	0	0	45	(1)
Total	$91,037	$ (1,124)	$ 4,869	$ (123)	$ 95,906	$ (1,247)

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

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
December 31, 2018		
Due in one year or less	$39,245	$39,040
Due after one year through five years	58,499	58,306
Due after five years through 10 years	26,009	26,077
Due after 10 years	878	870
Total	$ 124,631	$ 124,293

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.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, Canadian dollar, and Australian dollar.

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.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures.

Equity

Securities held in our equity 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. In the past, to hedge our price risk, we also used and designated equity derivatives as hedging instruments, including puts, calls, swaps, and forwards.

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Other

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.

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.

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.

Credit-Risk-Related Contingent Features

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

The following table presents the notional amounts of our outstanding derivative instruments measured in U.S. dollar equivalents:

(In millions)	December 31, 2018	June 30, 2018
Designated as Hedging Instruments		
Foreign exchange contracts sold	$ 8,954	$11,101
Not Designated as Hedging Instruments		

Foreign exchange contracts purchased	10,171	9,425
Foreign exchange contracts sold	12,089	13,374
Equity contracts purchased	51	49
Equity contracts sold	7	5
Other contracts purchased	1,302	878
Other contracts sold	468	472

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Fair Values of Derivative Instruments

The following table presents our derivative instruments:

(In millions)	Derivative Assets	Derivative Liabilities	Derivative Assets	Derivative Liabilities
	December 31, 2018		June 30, 2018	
Changes in Fair Value Recorded in Other Comprehensive Income				
Designated as Hedging Instruments				
Foreign exchange contracts	$112	$0	$174	$ 0
Changes in Fair Value Recorded in Net Income				
Designated as Hedging Instruments				
Foreign exchange contracts	2	(133)	95	0
Not Designated as Hedging Instruments				
Foreign exchange contracts	113	(93)	256	(197)
Equity contracts	2	(59)	2	(7)
Other contracts	13	(9)	11	(3)
Gross amounts of derivatives	242	(294)	538	(207)
Gross amounts of derivatives offset in the balance sheet	(128)	128	(152)	153
Cash collateral received	0	(112)	0	(235)
Net amounts of derivatives	$114	$(278)	$386	$ (289)
Reported as				

Short-term investments	$(11)	$0	$104	$ 0
Other current assets	121	0	260	0
Other long-term assets	4	0	22	0
Other current liabilities	0	(269)	0	(288)
Other long-term liabilities	0	(9)	0	(1)
Total	$114	$(278)	$386	$ (289)

Gross derivative assets and liabilities subject to legally enforceable master netting agreements for which we have elected to offset were $233 million and $294 million, respectively, as of December 31, 2018, and $533 million and $207 million, respectively, as of June 30, 2018.

The following table presents the fair value of our derivatives instruments on a gross basis:

(In millions)	Level 1	Level 2	Level 3	Total
December 31, 2018				
Derivative assets	$ 2	$238	$ 2	$242
Derivative liabilities	(3)	(291)	0	(294)
June 30, 2018				
Derivative assets	1	535	2	538
Derivative liabilities	(1)	(206)	0	(207)

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Fair Value Hedge Gains (Losses)

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Foreign Exchange Contracts				
Derivatives	$ (139)	$ 14	$ 11	$ 36
Hedged items	184	12	62	10
Total amount of ineffectiveness	$ 45	$ 26	$ 73	$ 46
Equity Contracts				
Derivatives	$ 0	$ (71)	$ 0	$ (307)
Hedged items	0	71	0	307
Total amount of ineffectiveness	$ 0	$ 0	$ 0	$ 0
Amount of equity contracts excluded from effectiveness assessment	$ 0	$ 20	$ 0	$ 60

Cash Flow Hedge Gains (Losses)

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

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

	2018	2017	2018	2017
Effective Portion				
Gains recognized in other comprehensive income (loss), net of tax of $3, $1, $3, and $1	$ 70	$ 10	$ 114	$ 15
Gains reclassified from accumulated other comprehensive income (loss) into revenue	88	19	180	130
Amount Excluded from Effectiveness Assessment and Ineffective Portion				
Losses recognized in other income (expense), net	(14)	(73)	(41)	(164)

We estimate that $116 million of net derivative gains included in AOCI as of December 31, 2018 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur for the three and six months ended December 31, 2018.

Non-designated Derivative Gains (Losses)

We recognized in other income (expense), net the following gains (losses) on derivatives not designated as hedging instruments:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Foreign exchange contracts	$ (79)	$ (115)	$ (109)	$ (184)
Equity contracts	0	(49)	1	(78)
Other contracts	8	(2)	4	9
Total	$ (71)	$ (166)	$ (104)	$ (253)

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NOTE 6 — INVENTORIES

The components of inventories were as follows:

(In millions)

	December 31, 2018	June 30, 2018
Raw materials	$ 455	$655
Work in process	61	54
Finished goods	1,445	1,953
Total	$ 1,961	$ 2,662

NOTE 7 — BUSINESS COMBINATIONS

GitHub Inc.

On October 25, 2018, we acquired GitHub, Inc. in a $7.5 billion stock transaction (inclusive of total cash payments of $1.3 billion in respect of vested GitHub equity awards and an indemnity escrow). The acquisition is expected to empower developers to achieve more at every stage of the development lifecycle, accelerate enterprise use of GitHub, and bring Microsoft’s developer tools and services to new audiences. The financial results of GitHub have been included in our consolidated financial statements since the date of the acquisition. GitHub is reported as part of our Intelligent Cloud segment.

The purchase price allocation as of the date of the acquisition was based on a preliminary valuation and is subject to revision as more detailed analyses are completed and additional information about the fair value of assets acquired and liabilities assumed becomes available.

The major classes of assets and liabilities to which we have preliminarily allocated the purchase price were as follows:

(In millions)

Cash, cash equivalents, and short-term investments	$234

Goodwill	5,441
Intangible assets	1,298
Other assets	157
Other liabilities	(206)
Total	$ 6,924

The goodwill recognized in connection with the acquisition is primarily attributable to anticipated synergies from future growth and is not expected to be deductible for tax purposes. We assigned the goodwill to our Intelligent Cloud segment.

Following are the details of the purchase price allocated to the intangible assets acquired:

(In millions)	Amount	Weighted Average Life
Customer-related	$679	8 years
Technology-based	447	5 years
Marketing-related	170	10 years
Contract-based	2	2 years
Total	$ 1,298	7 years

Transactions recognized separately from the preliminary purchase price allocation were approximately $600 million, primarily related to equity awards recognized as expense over the related service period.

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Other

For the six months ended December 31, 2018, we completed 11 additional acquisitions for $959 million, substantially all of which were paid in cash. These entities have been included in our consolidated results of operations since their respective acquisition dates.

NOTE 8 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30, 2018	Acquisitions	Other	December 31, 2018
Productivity and Business Processes	$23,823	$ 326	$(68)	$ 24,081
Intelligent Cloud	5,703	5,484 [(a)]	(20)	11,167
More Personal Computing	6,157	206	(34)	6,329
Total	$ 35,683	$ 6,016	$ (122)	$ 41,577

(a) Includes goodwill of $5.4 billion related to GitHub. See Note 7 – Business Combinations for further information.

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

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

NOTE 9 — INTANGIBLE ASSETS

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

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
	December 31, 2018			June 30, 2018		
Technology-based	$7,548	$ (5,383)	$ 2,165	$7,220	$ (5,018)	$ 2,202
Customer-related	4,741	(1,487)	3,254	4,031	(1,205)	2,826
Marketing-related	4,177	(1,197)	2,980	4,006	(1,071)	2,935
Contract-based	574	(491)	83	679	(589)	90
Total	$ 17,040[(a)]	$ (8,558)	$ 8,482	$ 15,936	$ (7,883)	$ 8,053

(a) Includes intangible assets of $1.3 billion related to GitHub. See Note 7 – Business Combinations for further information.

Intangible assets amortization expense was $530 million and $1.1 billion for the three and six months ended December 31, 2018, respectively, and $562 million and $1.1 billion for the three and six months ended December 31, 2017, respectively.

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

(In millions)	
Year Ending June 30,	
2019 (excluding the six months ended December 31, 2018)	$871
2020	1,503
2021	1,282
2022	1,182
2023	1,009
Thereafter	2,635
Total	$8,482

NOTE 10 — DEBT

Short-term Debt

As of December 31, 2018 and June 30, 2018, we had no commercial paper issued or outstanding. Effective August 31, 2018, we terminated our credit facilities, which served as back-up for our commercial paper program.

Long-term Debt

As of December 31, 2018, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $73.2 billion and $74.2 billion, respectively. As of June 30, 2018, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $76.2 billion and $77.5 billion, respectively. These estimated fair values are based on Level 2 inputs.

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

(In millions, except interest rates)	Face Value December 31, 2018	Face Value June 30, 2018	Stated Interest Rate	Effective Interest Rate
Notes				
November 3, 2018	$ 0	$ 1,750	1.300%	1.396%
December 6, 2018	0	1,250	1.625%	1.824%
June 1, 2019	1,000	1,000	4.200%	4.379%
August 8, 2019	2,500	2,500	1.100%	1.203%
November 1, 2019	18	18	0.500%	0.500%
February 6, 2020	1,500	1,500	1.850%	1.952%
February 12, 2020	1,500	1,500	1.850%	1.935%
October 1, 2020	1,000	1,000	3.000%	3.137%
November 3, 2020	2,250	2,250	2.000%	2.093%
February 8, 2021	500	500	4.000%	4.082%
August 8, 2021	2,750	2,750	1.550%	1.642%
December 6, 2021 [(a)]	2,001	2,044	2.125%	2.233%
February 6, 2022	1,750	1,750	2.400%	2.520%
February 12, 2022	1,500	1,500	2.375%	2.466%
November 3, 2022	1,000	1,000	2.650%	2.717%
November 15, 2022	750	750	2.125%	2.239%
May 1, 2023	1,000	1,000	2.375%	2.465%
August 8, 2023	1,500	1,500	2.000%	2.101%
December 15, 2023	1,500	1,500	3.625%	3.726%
February 6, 2024	2,250	2,250	2.875%	3.041%
February 12, 2025	2,250	2,250	2.700%	2.772%
November 3, 2025	3,000	3,000	3.125%	3.176%
August 8, 2026	4,000	4,000	2.400%	2.464%
February 6, 2027	4,000	4,000	3.300%	3.383%
December 6, 2028 [(a)]	2,001	2,044	3.125%	3.218%
May 2, 2033 [(a)]	629	642	2.625%	2.690%
February 12, 2035	1,500	1,500	3.500%	3.604%
November 3, 2035	1,000	1,000	4.200%	4.260%
August 8, 2036	2,250	2,250	3.450%	3.510%
February 6, 2037	2,500	2,500	4.100%	4.152%
June 1, 2039	750	750	5.200%	5.240%
October 1, 2040	1,000	1,000	4.500%	4.567%

February 8, 2041	1,000	1,000	5.300%	5.361%
November 15, 2042	900	900	3.500%	3.571%
May 1, 2043	500	500	3.750%	3.829%
December 15, 2043	500	500	4.875%	4.918%
February 12, 2045	1,750	1,750	3.750%	3.800%
November 3, 2045	3,000	3,000	4.450%	4.492%
August 8, 2046	4,500	4,500	3.700%	3.743%
February 6, 2047	3,000	3,000	4.250%	4.287%
February 12, 2055	2,250	2,250	4.000%	4.063%
November 3, 2055	1,000	1,000	4.750%	4.782%
August 8, 2056	2,250	2,250	3.950%	4.033%
February 6, 2057	2,000	2,000	4.500%	4.528%
Total	$ 73,799	$ 76,898		

(a) Euro-denominated debt securities.

The notes in the table above are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. As of December 31, 2018 and June 30, 2018, the aggregate debt issuance costs and unamortized discount associated with our long-term debt, including the current portion, were $630 million and $658 million, respectively.

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NOTE 11 — INCOME TAXES

Effective Tax Rate

Our effective tax rate was 19% and 169% for the three months ended December 31, 2018 and 2017, respectively, and 16% and 98% for the six months ended December 31, 2018 and 2017, respectively. The decrease in our effective tax rate for the three and six months ended December 31, 2018 compared to the prior year was primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018.

Our effective tax rate for the three and six months ended December 31, 2018 was lower than the U.S. federal statutory rate, primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico, and tax benefits relating to stock-based compensation.

Recent Tax Legislation

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

The TCJA was effective in the second quarter of fiscal year 2018. We recorded a provisional net charge of $13.8 billion in the second quarter of fiscal year 2018, and $13.7 billion for the fiscal year ended June 30, 2018, related to the TCJA based on reasonable estimates for those tax effects. We adjusted our provisional net charge by recording additional tax expense of $157 million in the second quarter of fiscal year 2019, related to GILTI deferred taxes pursuant to SEC Staff Accounting Bulletin No. 118. As of December 31, 2018, the U.S. Treasury Department and the Internal Revenue Service ("IRS") are still in the process of issuing various TCJA regulations. Accordingly, future adjustments to the financial statements may be necessary as regulations are issued and when we file our fiscal year 2018 tax returns with the IRS and foreign tax authorities in the current fiscal year.

We recorded an estimated charge of $17.8 billion in the second quarter of fiscal year 2018, and $17.9 billion in fiscal year 2018, related to the one-time transition tax on the deemed repatriation of deferred foreign income, which was included in the provision for income taxes on our consolidated income statements and income taxes on our consolidated balance sheets. To calculate the transition tax, we estimated our deferred foreign income for fiscal year 2018 because these tax returns are not complete or due. Taxable income for fiscal year 2018 will be known once the respective tax returns are completed and filed. In addition, U.S. and foreign audit settlements may significantly impact the estimated transition tax. The impact of the U.S. and foreign audits on the transition tax will be known as the audits are concluded.

In addition, we recorded an estimated benefit of $4.0 billion in the second quarter of fiscal year 2018, and $4.2 billion in fiscal year 2018, from the impact of changes in the tax rate, primarily on deferred tax assets and liabilities, which was included in provision for income taxes on our consolidated income statements and deferred income taxes and long-term income taxes on our consolidated balance sheets. We remeasured our deferred taxes to reflect the reduced rate that will apply when these deferred taxes are settled or realized in future periods. We adjusted our provisional charge by recording additional tax expense of $157 million in the second quarter of fiscal year 2019.

The TCJA subjects a U.S. corporation to tax on its GILTI. Under GAAP, we can make an accounting policy election to either treat taxes due on the GILTI inclusion as a current period expense or factor such amounts into our measurement of deferred taxes. We elected the deferred method, under which we recorded the corresponding deferred tax assets and liabilities on our consolidated balance sheets.

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Uncertain Tax Positions

While we settled a portion of the IRS audit for tax years 2004 to 2006 in the third quarter of fiscal year 2011, a portion of the IRS audit for tax years 2007 to 2009 in the first quarter of fiscal year 2016, and a portion of the IRS audit for tax years 2010 to 2013 in the second quarter of fiscal year 2018, we remain under audit for those years. We continue to be subject to examination by the IRS for tax years 2014 to 2017. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of December 31, 2018, the primary unresolved issues for this and other open IRS audits are related to transfer pricing. While we believe our allowances for income tax contingencies related to the unresolved issues are adequate, the final resolution of these issues, if unfavorable, could have a material impact on our consolidated financial statements. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2018, some of which are currently under audit by local tax authorities. The resolution of each of these audits is not expected to be material to our consolidated financial statements.

While we believe our allowances for all income tax contingencies are adequate, the final resolution of these issues, if unfavorable, could have a material impact on our consolidated financial statements. Income tax contingencies and other income tax liabilities were $15.4 billion and $15.1 billion as of December 31, 2018 and June 30, 2018, respectively, and are included in long-term income taxes on our consolidated balance sheets. This increase was primarily due to current period intercompany transactions and interest accruals.

NOTE 12 — UNEARNED REVENUE

Unearned revenue by segment was as follows:

(In millions)

	December 31, 2018	June 30, 2018
Productivity and Business Processes	$ 12,635	$ 14,864
Intelligent Cloud	12,551	14,706
More Personal Computing	2,898	3,150
Total	$ 28,084	$ 32,720

Changes in unearned revenue were as follows:

(In millions)	
Six Months Ended December 31, 2018	
Balance, beginning of period	$32,720
Deferral of revenue	30,450
Recognition of unearned revenue	(35,086)
Balance, end of period	$28,084

Revenue allocated to remaining performance obligations represents contracted revenue that has not yet been recognized ("contracted not recognized revenue"), which includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. Contracted not recognized revenue was $72 billion as of December 31, 2018, of which we expect to recognize approximately 60% of the revenue over the next 12 months and the remainder thereafter.

NOTE 13 — LEASES

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

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The components of lease expense were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Operating lease cost	$413	$399	$823	$787
Finance lease cost:				
Amortization of right-of-use assets	$84	$57	$162	$105
Interest on lease liabilities	59	44	114	74
Total finance lease cost	$143	$101	$276	$179

Supplemental cash flow information related to leases was as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Cash paid for amounts included in the measurement of lease liabilities:				
Operating cash flows from operating leases	$407	$375	$804	$744
Operating cash flows from finance leases	59	45	114	75
Financing cash flows from finance leases	54	31	101	56
Right-of-use assets obtained in exchange for lease obligations:				
Operating leases	472	308	968	699
Finance leases	645	650	1,064	1,378

Supplemental balance sheet information related to leases was as follows:

(In millions, except lease term and discount rate)

	December 31, 2018	June 30, 2018
Operating Leases		
Operating lease right-of-use assets	$6,806	$6,686
Other current liabilities	$1,421	$1,399
Operating lease liabilities	5,683	5,568
Total operating lease liabilities	$7,104	$6,967
Finance Leases		
Property and equipment, at cost	$5,554	$4,543
Accumulated depreciation	(566)	(404)
Property and equipment, net	$4,988	$4,139
Other current liabilities	$245	$176
Other long-term liabilities	4,965	4,125
Total finance lease liabilities	$5,210	$4,301
Weighted Average Remaining Lease Term		
Operating leases	7 years	7 years
Finance leases	13 years	13 years
Weighted Average Discount Rate		
Operating leases	2.9%	2.7%
Finance leases	4.9%	5.2%

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Maturities of lease liabilities were as follows:

(In millions)

Year Ending June 30,	Operating Leases	Finance Leases
2019 (excluding the six months ended December 31, 2018)	$ 799	$241
2020	1,503	479
2021	1,244	487
2022	1,048	495
2023	861	498
Thereafter	2,439	4,934
Total lease payments	7,894	7,134
Less imputed interest	(790)	(1,924)
Total	$ 7,104	$5,210

As of December 31, 2018, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $2.7 billion and $6.4 billion, respectively. These operating and finance leases will commence between fiscal year 2019 and fiscal year 2022 with lease terms of 1 year to 16 years.

NOTE 14 — CONTINGENCIES

Patent and Intellectual Property Claims

There were 32 patent infringement cases pending against Microsoft as of December 31, 2018, none of which are material individually or in aggregate.

Antitrust, Unfair Competition, and Overcharge Class Actions

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

The trial of the British Columbia action commenced in May 2016. Following a mediation, the parties agreed to a global settlement of all three Canadian actions, and submitted the proposed settlement agreement to the courts in all three jurisdictions for approval. The final settlement has been approved by the courts in British Columbia, Ontario, and Quebec, and the claims administration process will commence.

Other Antitrust Litigation and Claims

China State Administration for Industry and Commerce Investigation

In 2014, Microsoft was informed that China's State Agency for Market Regulation ("SAMR") (formerly State Administration for Industry and Commerce) had begun a formal investigation relating to China's Anti-Monopoly Law, and the SAMR conducted onsite inspections of Microsoft offices in Beijing, Shanghai, Guangzhou, and Chengdu. In December 2018, the SAMR met with Microsoft representatives and presented their preliminary views as to certain possible violations of China's Anti-Monopoly Law, to which they have invited Microsoft to respond.

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Product-Related Litigation

U.S. Cell Phone Litigation

Microsoft Mobile Oy, a subsidiary of Microsoft, along with other handset manufacturers and network operators, is a defendant in 40 lawsuits filed in the Superior Court for the District of Columbia by individual plaintiffs who allege that radio emissions from cellular handsets caused their brain tumors and other adverse health effects. We assumed responsibility for these claims in our agreement to acquire Nokia's Devices and Services business and have been substituted for the Nokia defendants. Nine of these cases were filed in 2002 and are consolidated for certain pre-trial proceedings; the remaining cases are stayed. In a separate 2009 decision, the Court of Appeals for the District of Columbia held that adverse health effect claims arising from the use of cellular handsets that operate within the U.S. Federal Communications Commission radio frequency emission guidelines ("FCC Guidelines") are pre-empted by federal law. The plaintiffs allege that their handsets either operated outside the FCC Guidelines or were manufactured before the FCC Guidelines went into effect. The lawsuits also allege an industry-wide conspiracy to manipulate the science and testing around emission guidelines.

In 2013, the defendants in the consolidated cases moved to exclude the plaintiffs' expert evidence of general causation on the basis of flawed scientific methodologies. In 2014, the trial court granted in part and denied in part the defendants' motion to exclude the plaintiffs' general causation experts. The defendants filed an interlocutory appeal to the District of Columbia Court of Appeals challenging the standard for evaluating expert scientific evidence. In October 2016, the Court of Appeals issued its decision adopting the standard advocated by the defendants and remanding the cases to the trial court for further proceedings under that standard. The plaintiffs have filed supplemental expert evidence, portions of which the defendants have moved to strike. In August 2018, the trial court issued an order striking portions of the plaintiffs' expert reports.

Canadian Cell Phone Class Action

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

Employment-Related Litigation

Moussouris v. Microsoft

Current and former female Microsoft employees in certain engineering and information technology roles brought this class action in federal court in Seattle in 2015, alleging systemic gender discrimination in pay and promotions. The plaintiffs moved to certify the class in October 2017. Microsoft filed an opposition in January 2018, attaching an expert report showing no statistically significant disparity in pay and promotions between similarly situated men and women. In June 2018, the court denied the plaintiffs' motion for class certification. Plaintiffs sought an interlocutory appeal to the U.S. Court of Appeals for the Ninth Circuit, which was granted in September 2018.

Other Contingencies

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

As of December 31, 2018, we accrued aggregate legal liabilities of $273 million. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $1.0 billion in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our consolidated financial statements for the period in which the effects become reasonably estimable.

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NOTE 15 — STOCKHOLDERS' EQUITY

Share Repurchases

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing up to $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016, has no expiration date, and may be suspended or discontinued at any time without notice. As of December 31, 2018, $19.5 billion remained of this $40.0 billion share repurchase program.

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

(In millions)	Shares	Amount	Shares	Amount
Fiscal Year		2019		2018
First Quarter	24	$2,600	22	$1,600
Second Quarter	57	6,100	22	1,800
Total	81	$8,700	44	$3,400

The above table excludes shares repurchased to settle employee tax withholding related to the vesting of stock awards. All repurchases were made using cash resources.

Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Record Date	Payment Date	Dividend Per Share	Amount
Fiscal Year 2019				(in millions)
September 18, 2018	November 15, 2018	December 13, 2018	$ 0.46	$ 3,544

November 28, 2018	February 21, 2019	March 14, 2019	0.46	3,535
Total			$ 0.92	$ 7,079

Fiscal Year 2018

September 19, 2017	November 16, 2017	December 14, 2017	$ 0.42	$ 3,238
November 29, 2017	February 15, 2018	March 8, 2018	0.42	3,232
Total			$ 0.84	$ 6,470

The dividend declared on November 28, 2018 was included in other current liabilities as of December 31, 2018.

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NOTE 16 — ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Derivatives				
Balance, beginning of period	$128	$28	$173	$134
Unrealized gains, net of tax of $3, $1, $2, and $1	71	11	115	15
Reclassification adjustments for gains included in revenue	(88)	(19)	(180)	(130)
Tax expense included in provision for income taxes	2	1	5	2
Amounts reclassified from accumulated other comprehensive income (loss)	(86)	(18)	(175)	(128)
Net change related to derivatives, net of tax of $1, $0, $(3), and $(1)	(15)	(7)	(60)	(113)
Balance, end of period	$113	$21	$113	$21
Investments				
Balance, beginning of period	$(1,178)	$1,537	$(850)	$1,825
Unrealized gains (losses), net of tax of $234, $(211), $148, and $(161)	879	(390)	556	(317)
Reclassification adjustments for (gains) losses included in other income (expense), net	2	(751)	80	(1,306)
Tax expense (benefit) included in provision for income taxes	0	263	(16)	457
Amounts reclassified from accumulated other comprehensive income (loss)	2	(488)	64	(849)

Net change related to investments, net of tax of $234, $(474), $164, and $(618)	881	(878)	620	(1,166)
Cumulative effect of accounting changes	0	0	(67)	0
Balance, end of period	$(297)	$659	$(297)	$659
Translation Adjustments and Other				
Balance, beginning of period	$(1,565)	$(1,039)	$(1,510)	$(1,332)
Translation adjustments and other, net of tax of $(1), $0, $(1), and $(1)	(264)	(40)	(319)	253
Balance, end of period	$(1,829)	$(1,079)	$(1,829)	$(1,079)
Accumulated other comprehensive loss, end of period	$(2,013)	$(399)	$(2,013)	$(399)

NOTE 17 — SEGMENT INFORMATION AND GEOGRAPHIC DATA

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

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Our reportable segments are described below.

Productivity and Business Processes

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

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

Intelligent Cloud

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

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

More Personal Computing

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

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

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

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

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Revenue				
Productivity and Business Processes	$ 10,100	$ 8,953	$ 19,871	$ 17,191
Intelligent Cloud	9,378	7,795	17,945	14,717
More Personal Computing	12,993	12,170	23,739	21,548
Total	$ 32,471	$ 28,918	$ 61,555	$ 53,456
Operating Income				
Productivity and Business Processes	$ 4,015	$ 3,337	$ 7,896	$ 6,343
Intelligent Cloud	3,279	2,832	6,210	4,969
More Personal Computing	2,964	2,510	6,107	5,075
Total	$ 10,258	$ 8,679	$ 20,213	$ 16,387

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017

United States [a]	$ 16,787	$ 15,110	$ 31,527	$ 27,657
Other countries	15,684	13,808	30,028	25,799
Total	$ 32,471	$ 28,918	$ 61,555	$ 53,456

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

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Office products and cloud services	$ 7,747	$ 7,075	$ 15,369	$ 13,651
Server products and cloud services	7,791	6,299	14,849	11,796
Windows	4,758	4,839	9,659	9,482
Gaming	4,232	3,920	6,970	5,816
Search advertising	1,976	1,820	3,764	3,459
LinkedIn	1,693	1,312	3,223	2,460
Devices	1,948	1,478	3,209	2,632
Enterprise Services	1,521	1,435	2,971	2,806
Other	805	740	1,541	1,354
Total	$ 32,471	$ 28,918	$ 61,555	$ 53,456

Our commercial cloud revenue, which includes Office 365 commercial, Azure, the commercial portion of LinkedIn, Dynamics 365, and other commercial cloud properties, was $9.0 billion and $17.5 billion for the three and six months ended December 31, 2018, respectively, and $6.1 billion and $11.9 billion for the three and six months ended December 31, 2017, respectively. These amounts are primarily included in Office products and cloud services, Server products and cloud services, and LinkedIn in the table above.

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of Microsoft Corporation

Results of Review of Interim Financial Information

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the "Company") as of December 31, 2018, the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the three-month and six-month periods ended December 31, 2018 and 2017, and the related notes (collectively referred to as the "interim financial information"). Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim financial information for it 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) ("PCAOB"), the consolidated balance sheet of the Company as of June 30, 2018, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for the year then ended (not presented herein); and in our report dated August 3, 2018, we expressed an unqualified opinion on those consolidated financial statements and included an explanatory paragraph regarding a change in accounting principles. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2018, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

This interim financial information is the responsibility of the Company's management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the PCAOB and the Securities and Exchange Commission.

We conducted our reviews in accordance with standards of the PCAOB. 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 PCAOB, 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.

/S/ DELOITTE & TOUCHE LLP

Seattle, Washington

January 30, 2019

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

Note About Forward-Looking Statements

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our Annual Report on Form 10-K for the year ended June 30, 2018, and our financial statements and the accompanying Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

OVERVIEW

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

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

Highlights from the second quarter of fiscal year 2019 compared with the second quarter of fiscal year 2018 included:

- Commercial cloud revenue, which includes Microsoft Office 365 commercial, Microsoft Azure, the commercial portion of LinkedIn, Microsoft Dynamics 365, and other commercial cloud properties, increased 48% to $9.0 billion.
- Office Commercial revenue increased 11%, driven by Office 365 commercial growth of 34%.
- Office Consumer revenue increased 1%, with continued growth in Office 365 consumer subscribers to 33.3 million.
- LinkedIn revenue increased 29%, with strong engagement highlighted by LinkedIn sessions growth of 30%.

- Dynamics revenue increased 17%, driven by Dynamics 365 growth of 51%.
- Server products and cloud services revenue, including GitHub, increased 24%, driven by Azure growth of 76%.
- Enterprise Services revenue increased 6%.
- Windows original equipment manufacturer licensing ("Windows OEM") revenue decreased 5%.
- Windows Commercial revenue increased 13%.
- Microsoft Surface revenue increased 39%.

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- Gaming revenue increased 8%, with Xbox software and services growth of 31%.
- Search advertising revenue, excluding traffic acquisition costs, increased 14%.

We have recast certain prior period commercial cloud metrics to include the commercial portion of LinkedIn to provide a comparable view of our commercial cloud business performance. The commercial portion of LinkedIn includes LinkedIn Recruiter, Sales Navigator, premium business subscriptions, and other services for organizations.

On October 25, 2018, we acquired GitHub, Inc. in a $7.5 billion stock transaction (inclusive of total cash payments of $1.3 billion in respect of vested GitHub equity awards and an indemnity escrow). The financial results of GitHub have been included in our consolidated financial statements since the date of the acquisition. GitHub is reported as part of our Intelligent Cloud segment. Refer to Note 7 – Business Combinations of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted into law, which significantly changed existing U.S. tax law and includes numerous provisions that affect our business. We recorded a provisional net charge of $13.8 billion in the second quarter of fiscal year 2018, and $13.7 billion in fiscal year 2018, related to the TCJA. We adjusted our provisional net charge by recording additional tax expense of $157 million in the second quarter of fiscal year 2019. Refer to Note 11 – Income Taxes of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Industry Trends

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

Economic Conditions, Challenges, and Risks

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

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

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. Strengthening of foreign currencies relative to the U.S. dollar

throughout fiscal year 2018 positively impacted reported revenue and increased reported expenses from our international operations. Strengthening of the U.S. dollar relative to certain foreign currencies in the first and second quarters of fiscal year 2019 has not significantly impacted reported revenue or expenses from our international operations.

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

Seasonality

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

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Reportable Segments

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

Additional information on our reportable segments is contained in Note 17 – Segment Information and Geographic Data of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2018	2017		2018	2017	
Revenue	$32,471	$28,918	12%	$61,555	$53,456	15%
Gross margin	20,048	17,854	12%	39,227	34,114	15%
Operating income	10,258	8,679	18%	20,213	16,387	23%
Net income (loss)	8,420	(6,302)	*	17,244	274	*
Diluted earnings (loss) per share	1.08	(0.82)	*	2.22	0.04	*
Non-GAAP net income	8,577	7,498	14%	17,401	14,074	24%
Non-GAAP diluted earnings per share	1.10	0.96	15%	2.24	1.80	24%

*Not meaningful.
Non-GAAP net income and diluted earnings per share ("EPS") exclude the net charge related to the TCJA. Refer to the Non-GAAP Financial Measures section below for a reconciliation of our financial results reported in accordance with GAAP to non-GAAP financial results.

Three Months Ended December 31, 2018 Compared with Three Months Ended December 31, 2017

Revenue increased $3.6 billion or 12%, driven by growth across each of our segments. Intelligent Cloud revenue increased, driven by server products and cloud services. Productivity and Business Processes revenue increased, driven by Office and LinkedIn. More Personal Computing revenue increased, driven by Surface and Gaming.

Gross margin increased $2.2 billion or 12%, driven by growth across each of our segments. Gross margin percentage was relatively unchanged, due to gross margin percentage decline in Productivity and Business Processes and More Personal Computing, offset by favorable segment sales mix. Gross margin included a 5 percentage point improvement

in commercial cloud, primarily from Azure.

Operating income increased $1.6 billion or 18%, driven by growth across each of our segments.

Key changes in expenses were:

- Cost of revenue increased $1.4 billion or 12%, driven by growth in commercial cloud and Surface.
- Research and development expenses increased $566 million or 16%, driven by investments in cloud engineering.
- Sales and marketing expenses increased $26 million or 1%, driven by investments in commercial sales capacity, offset in part by a decrease in marketing.

Current year net income and diluted EPS were negatively impacted by the net charge related to TCJA, which resulted in a decrease to net income and diluted EPS of $157 million and $0.02, respectively. Prior year net loss and diluted EPS were negatively impacted by the net charge related to TCJA, which resulted in a decrease to net income and diluted EPS of $13.8 billion and $1.78, respectively.

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Six Months Ended December 31, 2018 Compared with Six Months Ended December 31, 2017

Revenue increased $8.1 billion or 15%, driven by growth across each of our segments. Intelligent Cloud revenue increased, driven by server products and cloud services. Productivity and Business Processes revenue increased, driven by Office and LinkedIn. More Personal Computing revenue increased, driven by Gaming and Surface.

Gross margin increased $5.1 billion or 15%, driven by growth across each of our segments. Gross margin percentage was relatively unchanged, due to gross margin percentage decline in More Personal Computing and Productivity and Business Processes, offset by gross margin percentage improvement in Intelligent Cloud and favorable segment sales mix. Gross margin included a 5 percentage point improvement in commercial cloud, primarily from Azure.

Operating income increased $3.8 billion or 23%, driven by growth across each of our segments.

Key changes in expenses were:

- Cost of revenue increased $3.0 billion or 15%, driven by growth in commercial cloud, Gaming, and Surface.
- Research and development expenses increased $969 million or 14%, driven by investments in cloud engineering.
- Sales and marketing expenses increased $312 million or 4%, driven by investments in commercial sales capacity, offset in part by a decrease in marketing.

Current year net income and diluted EPS were negatively impacted by the net charge related to TCJA, which resulted in a decrease to net income and diluted EPS of $157 million and $0.02, respectively. Prior year net income and diluted EPS were negatively impacted by the net charge related to TCJA, which resulted in a decrease to net income and diluted EPS of $13.8 billion and $1.76, respectively.

SEGMENT RESULTS OF OPERATIONS

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2018	2017		2018	2017	
Revenue						
Productivity and Business Processes	$ 10,100	$ 8,953	13%	$ 19,871	$ 17,191	16%
Intelligent Cloud	9,378	7,795	20%	17,945	14,717	22%
More Personal Computing	12,993	12,170	7%	23,739	21,548	10%
Total	$ 32,471	$ 28,918	12%	$ 61,555	$ 53,456	15%

Operating Income

Productivity and Business Processes	$ 4,015	$ 3,337	20%	$ 7,896	$ 6,343	24%
Intelligent Cloud	3,279	2,832	16%	6,210	4,969	25%
More Personal Computing	2,964	2,510	18%	6,107	5,075	20%
Total	$ 10,258	$ 8,679	18%	$ 20,213	$ 16,387	23%

Reportable Segments

Three Months Ended December 31, 2018 Compared with Three Months Ended December 31, 2017

Productivity and Business Processes

Revenue increased $1.1 billion or 13%.

- Office Commercial revenue increased $669 million or 11%, driven by Office 365 commercial, due to growth in subscribers and average revenue per user, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.
- Office Consumer revenue increased $13 million or 1%, driven by Office 365 consumer, due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 consumer.

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- LinkedIn revenue increased $381 million or 29%, with strong engagement highlighted by LinkedIn sessions growth.
- Dynamics revenue increased 17%, driven by Dynamics 365 growth.

Operating income increased $678 million or 20%.

- Gross margin increased $780 million or 11% driven by growth in Office Commercial and LinkedIn. Gross margin percentage decreased, due to an increased mix of cloud offerings, offset in part by gross margin percentage improvement in LinkedIn and Office 365 commercial.
- Operating expenses increased $102 million or 3%, driven by investments in LinkedIn and cloud engineering, offset in part by a decrease in marketing.

Intelligent Cloud

Revenue increased $1.6 billion or 20%.

- Server products and cloud services revenue, including GitHub, increased $1.5 billion or 24%, driven by Azure. Azure revenue growth was 76%, due to higher infrastructure-as-a-service and platform-as-a-service consumption-based and per user-based services. Server products revenue increased 3%, due to a higher mix of premium licenses for Windows Server and GitHub.
- Enterprise Services revenue increased $86 million or 6%, driven by growth in Premier Support Services and Microsoft Consulting Services.

Operating income increased $447 million or 16%.

- Gross margin increased $1.1 billion or 20%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies. Gross margin percentage increased slightly, due to gross margin percentage improvement in Azure, offset by an increased mix of cloud offerings.
- Operating expenses increased $644 million or 26%, driven by investments in cloud and artificial intelligence (“AI”) engineering, GitHub, and commercial sales capacity.

More Personal Computing

Revenue increased $823 million or 7%.

- Windows revenue decreased $81 million or 2%, driven by a decrease in Windows OEM and patent licensing, offset in part by growth in Windows Commercial. Windows OEM revenue decreased 5%. Windows OEM non-Pro revenue declined 11%, below the consumer PC market, with continued pressure in the entry-level category. Windows OEM Pro revenue declined 2%, in line with the commercial PC market. Windows Commercial revenue increased 13%, with continued customer adoption of premium offerings.
- Surface revenue increased $525 million or 39%, with strong growth across consumer and commercial.
- Gaming revenue increased $312 million or 8%, driven by Xbox software and services growth of 31%, primarily due to third-party title strength, offset in part by a decline in Xbox hardware of 19% due to the launch of Xbox One X in the second quarter of fiscal year 2018.
- Search advertising revenue increased $156 million or 9%. Search advertising revenue, excluding traffic acquisition costs, increased 14%, driven by growth in Bing, due to higher revenue per search and search volume.

Operating income increased $454 million or 18%.

- Gross margin increased $323 million or 6%, driven by growth in Gaming and Search. Gross margin percentage decreased slightly, due to sales mix shift to our lower margin Surface and Gaming businesses.

- Operating expenses decreased $131 million or 4%, driven by a decline in Windows and Gaming marketing.

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Six Months Ended December 31, 2018 Compared with Six Months Ended December 31, 2017

Productivity and Business Processes

Revenue increased $2.7 billion or 16%.

- Office Commercial revenue increased $1.6 billion or 14%, driven by Office 365 commercial, due to growth in subscribers and average revenue per user, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.
- Office Consumer revenue increased $153 million or 8%, driven by Office 365 consumer, due to growth in subscribers.
- LinkedIn revenue increased $763 million or 31%, with strong engagement highlighted by LinkedIn sessions growth.
- Dynamics revenue increased 18%, driven by Dynamics 365 growth.

Operating income increased $1.6 billion or 24%.

- Gross margin increased $1.9 billion or 14%, driven by growth in Office Commercial and LinkedIn. Gross margin percentage decreased slightly, due to an increased mix of cloud offerings, offset in part by gross margin percentage improvement in LinkedIn and Office 365 commercial.
- Operating expenses increased $330 million or 5%, driven by investments in LinkedIn and cloud engineering, offset in part by a decrease in marketing.

Intelligent Cloud

Revenue increased $3.2 billion or 22%.

- Server products and cloud services revenue, including GitHub, increased $3.1 billion or 26%, driven by Azure. Azure revenue growth was 76%, due to higher infrastructure-as-a-service and platform-as-a-service consumption-based and per user-based services. Server products revenue increased 6%, due to a higher mix of premium licenses for Windows Server.
- Enterprise Services revenue increased $165 million or 6%, driven by growth in Premier Support Services and Microsoft Consulting Services.

Operating income increased $1.2 billion or 25%.

- Gross margin increased $2.4 billion or 24%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies. Gross margin percentage increased, due to gross margin percentage improvement in Azure, offset in part by an increased mix of cloud offerings.
- Operating expenses increased $1.1 billion or 23%, driven by investments in cloud and AI engineering, commercial sales capacity, and GitHub.

More Personal Computing

Revenue increased $2.2 billion or 10%.

- Windows revenue increased $177 million or 2%, driven by growth in Windows Commercial, offset in part by a decline in patent licensing and Windows OEM. Windows Commercial revenue increased 13%, with continued customer adoption of premium offerings. Windows OEM revenue decreased 1%. Windows OEM Pro revenue grew 3%, slightly ahead of the commercial PC market. Windows OEM non-Pro revenue declined 8%, below the consumer

PC market, with continued pressure in the entry-level category.

- Gaming revenue increased $1.2 billion or 20%, driven by Xbox software and services growth of 33%, primarily due to third-party title strength, offset in part by a decline in Xbox hardware of 4%.
- Surface revenue increased $668 million or 28%, with strong growth across consumer and commercial.
- Search advertising revenue increased $305 million or 9%. Search advertising revenue, excluding traffic acquisition costs, increased 15%, driven by growth in Bing, due to higher revenue per search and search volume.

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Operating income increased $1.0 billion or 20%.

- Gross margin increased $870 million or 8%, driven by growth in Gaming, Windows, and Search. Gross margin percentage decreased, due to sales mix shift to lower gross margin Surface and Gaming businesses.
- Operating expenses decreased $162 million or 3%, driven by a decline in Windows marketing.

OPERATING EXPENSES

Research and Development

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2018	2017		2018	2017	
Research and development	$ 4,070	$ 3,504	16%	$ 8,047	$ 7,078	14%
As a percent of revenue	13%	12%	1ppt	13%	13%	0ppt

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

Three Months Ended December 31, 2018 Compared with Three Months Ended December 31, 2017

Research and development expenses increased $566 million or 16%, driven by investments in cloud engineering.

Six Months Ended December 31, 2018 Compared with Six Months Ended December 31, 2017

Research and development expenses increased $969 million or 14%, driven by investments in cloud engineering.

Sales and Marketing

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

	2018	2017		2018	2017	
Sales and marketing	$ 4,588	$ 4,562	1%	$ 8,686	$ 8,374	4%
As a percent of revenue	14%	16%	(2)ppt	14%	16%	(2)ppt

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

Three Months Ended December 31, 2018 Compared with Three Months Ended December 31, 2017

Sales and marketing expenses increased $26 million or 1%, driven by investments in commercial sales capacity, offset in part by a decrease in marketing.

Six Months Ended December 31, 2018 Compared with Six Months Ended December 31, 2017

Sales and marketing expenses increased $312 million or 4%, driven by investments in commercial sales capacity, offset in part by a decrease in marketing.

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General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2018	2017		2018	2017	
General and administrative	$ 1,132	$ 1,109	2%	$ 2,281	$ 2,275	0%
As a percent of revenue	3%	4%	(1)ppt	4%	4%	0ppt

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

Three Months Ended December 31, 2018 Compared with Three Months Ended December 31, 2017

General and administrative expenses increased $23 million or 2%.

Six Months Ended December 31, 2018 Compared with Six Months Ended December 31, 2017

General and administrative expenses increased slightly.

OTHER INCOME (EXPENSE), NET

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Interest and dividends income	$ 704	$ 530	$1,385	$1,003
Interest expense	(672)	(698)	(1,346)	(1,370)
Net recognized gains on investments	94	768	337	1,341
Net gains (losses) on derivatives	41	(84)	38	(134)

Net losses on foreign currency remeasurements	(74)	(60)	(69)	(69)
Other, net	34	34	48	(5)
Total	$ 127	$ 490	$393	$766

We use derivative instruments to: manage risks related to foreign currencies, equity prices, interest rates, and credit; enhance investment returns; and facilitate portfolio diversification. Gains and losses from changes in fair values of derivatives that are not designated as hedging instruments are primarily recognized in other income (expense), net.

Three Months Ended December 31, 2018 Compared with Three Months Ended December 31, 2017

Interest and dividends income increased primarily due to higher yields on fixed-income securities. Interest expense decreased primarily driven by a decrease in outstanding long-term debt due to debt maturities, offset in part by higher finance lease expense. Net recognized gains on investments decreased primarily due to lower gains on sales of equity investments. Net gains on derivatives includes gains on foreign exchange derivatives in the current period as compared to losses in the prior period.

Six Months Ended December 31, 2018 Compared with Six Months Ended December 31, 2017

Interest and dividends income increased primarily due to higher yields on fixed-income securities. Interest expense decreased primarily driven by a decrease in outstanding long-term debt due to debt maturities, offset in part by higher finance lease expense. Net recognized gains on investments decreased primarily due to lower gains on sales of equity investments. Net gains on derivatives includes gains on foreign exchange derivatives in the current period as compared to losses in the prior period.

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INCOME TAXES

Effective Tax Rate

Our effective tax rate was 19% and 169% for the three months ended December 31, 2018 and 2017, respectively, and 16% and 98% for the six months ended December 31, 2018 and 2017, respectively. The decrease in our effective tax rate for the three and six months ended December 31, 2018 compared to the prior year was primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018.

Our effective tax rate for the three and six months ended December 31, 2018 was lower than the U.S. federal statutory rate, primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico, and tax benefits relating to stock-based compensation.

Recent Tax Legislation

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

The TCJA was effective in the second quarter of fiscal year 2018. We recorded a provisional net charge of $13.8 billion in the second quarter of fiscal year 2018, and $13.7 billion for the fiscal year ended June 30, 2018, related to the TCJA. We adjusted our provisional net charge by recording additional tax expense of $157 million in the second quarter of fiscal year 2019 related to GILTI deferred taxes pursuant to SEC Staff Accounting Bulletin No. 118. Refer to Note 11 – Income Taxes of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Uncertain Tax Positions

While we settled a portion of the Internal Revenue Service ("IRS") audit for tax years 2004 to 2006 in the third quarter of fiscal year 2011, a portion of the IRS audit for tax years 2007 to 2009 in the first quarter of fiscal year 2016, and a portion of the IRS audit for tax years 2010 to 2013 in the second quarter of fiscal year 2018, we remain under audit for those years. We continue to be subject to examination by the IRS for tax years 2014 to 2017. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of December 31, 2018, the primary unresolved issues for this and other open IRS audits are related to transfer pricing. While we believe our allowances for income tax contingencies related to the unresolved issues are adequate, the final resolution of these issues, if unfavorable, could have a material impact on our consolidated financial statements. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a

significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2018, some of which are currently under audit by local tax authorities. The resolution of each of these audits is not expected to be material to our consolidated financial statements.

NON-GAAP FINANCIAL MEASURES

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

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

(In millions, except percentages and per share amounts)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2018	2017		2018	2017	
Net income (loss)	$ 8,420	$ (6,302)	*	$ 17,244	$ 274	*
Net charge related to the TCJA	157	13,800	*	157	13,800	*
Non-GAAP net income	$ 8,577	$ 7,498	14%	$ 17,401	$ 14,074	24%
Diluted earnings (loss) per share	$ 1.08	$ (0.82)	*	$ 2.22	$ 0.04	*
Net charge related to the TCJA	0.02	1.78	*	0.02	1.76	*
Non-GAAP diluted earnings per share	$ 1.10	$ 0.96	15%	$ 2.24	$ 1.80	24%

*Not meaningful.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $127.7 billion and $133.8 billion as of December 31, 2018 and June 30, 2018, respectively. Equity investments were $2.3 billion and $1.9 billion as of December 31, 2018 and June 30, 2018, respectively. Our short-term investments are primarily intended to facilitate liquidity and capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities.

Valuation

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

government securities, common and preferred stock, and mutual funds. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments, such as commercial paper, certificates of deposit, U.S. agency securities, foreign government bonds, mortgage- and asset-backed securities, corporate notes and bonds, and municipal securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured at fair value on a recurring basis using unobservable inputs are an immaterial portion of our portfolio.

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

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Cash Flows

Cash from operations increased $2.2 billion to $22.6 billion for the six months ended December 31, 2018, mainly due to an increase in cash received from customers, offset in part by an increase in cash paid to suppliers and employees, and cash paid for income taxes. Cash used in financing increased $12.7 billion to $20.6 billion for the six months ended December 31, 2018, mainly due to a $5.7 billion decrease in proceeds from issuances of debt, net of repayments, and a $5.6 billion increase in common stock repurchases. Cash used in investing decreased $82 million to $7.2 billion for the six months ended December 31, 2018, mainly due to a $4.2 billion decrease in net investment purchases, sales, and maturities, offset in part by a $2.6 billion increase in additions to property and equipment and a $1.6 billion increase in cash used for acquisitions of companies, net of cash acquired, and purchases of intangible and other assets.

Debt

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

Unearned Revenue

Unearned revenue comprises mainly unearned revenue related to volume licensing programs and includes Software Assurance (“SA”) and cloud services. Unearned revenue is generally billed upfront at the beginning of each annual coverage period for multi-year agreements and recognized ratably over the coverage period. Unearned revenue also includes payments for other offerings for which we have been paid in advance and earn the revenue when we transfer control of the product or service.

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

(In millions)	
Three Months Ending	
March 31, 2019	$11,483
June 30, 2019	7,381
September 30, 2019	3,434
December 31, 2019	1,987
Thereafter	3,799
Total	$28,084

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

Share Repurchases

For the six months ended December 31, 2018 and 2017, we repurchased 81 million shares and 44 million shares of our common stock for $8.7 billion and $3.4 billion, respectively, through our share repurchase programs. All repurchases were made using cash resources. Refer to Note 15 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Dividends

Refer to Note 15 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

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Off-Balance Sheet Arrangements

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

Other Planned Uses of Capital

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

Liquidity

As a result of the TCJA, we are required to pay a one-time transition tax of $17.9 billion on deferred foreign income not previously subject to U.S. income tax. We have paid transition tax of approximately $1.8 billion, which included $1.5 billion for the six months ended December 31, 2018. Under the TCJA, the remaining transition tax of $16.1 billion is payable interest free over the next seven years, with 8% due in each of the next four years, 15% in fiscal year 2024, 20% in fiscal year 2025, and 25% in fiscal year 2026.

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

RECENT ACCOUNTING GUIDANCE

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

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

Revenue Recognition

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

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

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

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

Our products are generally sold with a right of return, we may provide other credits or incentives, and in certain instances we estimate customer usage of our products and services, which are accounted for as variable consideration when determining the amount of revenue to recognize. Returns and credits are estimated at contract inception and updated at the end of each reporting period if additional information becomes available. Changes to our estimated variable consideration were not material for the periods presented.

Impairment of Investment Securities

We review debt investments quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, and the duration and extent to which the fair value is less than cost. 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. In addition, we 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 in other income (expense), net and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

Equity investments without readily determinable fair values are written down to fair value if a qualitative assessment indicates that the investment is impaired and the fair value of the investment is less than carrying value. We perform a qualitative assessment on a quarterly basis. We are required to estimate the fair value of the investment to determine the amount of the impairment loss. Once an investment is determined to be impaired, an impairment charge is recorded in other income (expense), net.

Goodwill

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value

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

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

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

Research and Development Costs

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

Legal and Other Contingencies

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

Income Taxes

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

The TCJA significantly changes existing U.S. tax law and includes numerous provisions that affect our business. Refer to Note 11 – Income Taxes of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

Inventories

Inventories are stated at average cost, subject to the lower of cost or net realizable value. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. Net realizable value is the

estimated selling price less estimated costs of completion, disposal, and transportation. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. These reviews include analysis of demand forecasts, product life cycle status, product development plans, current sales levels, pricing strategy, and component cost trends. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue.

PART I

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign exchange rates, interest rates, credit risk, and equity prices. We use derivatives instruments to manage these risks, however, they may still impact our consolidated financial statements.

Foreign Currency

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

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of the fixed-income portfolio to achieve economic returns that correlate to certain global fixed-income indices.

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We manage credit exposures relative to broad-based indices and to facilitate portfolio diversification.

Equity

Securities held in our equity investments portfolio are subject to price risk.

SENSITIVITY ANALYSIS

The following table sets forth the potential loss in future earnings or fair values, including associated derivatives, resulting from hypothetical changes in relevant market rates or prices:

(In millions)

		December 31,	
Risk Categories	Hypothetical Change	2018	Impact
Foreign currency - Revenue	10% decrease in foreign exchange rates	$ (2,228)	Earnings
Foreign currency - Investments	10% decrease in foreign exchange rates	(120)	Fair Value
Interest rate	100 basis point increase in U.S. treasury interest rates	(2,811)	Fair Value

Credit	100 basis point increase in credit spreads	(222)	Fair Value
Equity	10% decrease in equity market prices	(152)	Earnings

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, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

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

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

Competition in the technology sector

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

Competition among platform-based ecosystems

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

- A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has succeeded with some consumer products such as personal computers, tablets, phones, gaming consoles, and wearables. Competitors pursuing this model also earn revenue from services integrated with the hardware and software platform, including applications and content sold through their integrated marketplaces. They may also be able to claim security and performance benefits from their vertically integrated offer. We also offer some vertically-integrated hardware and software products and services. To the extent we shift a portion of our business to a vertically integrated model we increase our cost of revenue and reduce our operating margins.
- We derive substantial revenue from licenses of Windows operating systems on personal computers. We face significant competition from competing platforms developed for new devices and form factors such as smartphones

and tablet computers. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users are increasingly turning to these devices to perform functions that in the past were performed by personal computers. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract application developers to our PC operating system platforms. Competing with operating systems licensed at low or no cost may decrease our PC operating system margins. Popular products or services offered on competing platforms could increase their competitive strength. In addition, some of our devices compete with products made by our original equipment manufacturer ("OEM") partners, which may affect their commitment to our platform.

- Competing platforms have content and application marketplaces with scale and significant installed bases. The variety and utility of content and applications available on a platform are important to device purchasing decisions. Users sometimes incur costs to move data and buy new content and applications when switching platforms. To compete, we must successfully enlist developers to write applications for our platform and ensure that these applications have high quality, security, customer appeal, and value. Efforts to compete with competitors' content and application marketplaces may increase our cost of revenue and lower our operating margins.

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Business model competition

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

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

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

Our increasing focus on cloud-based services presents execution and competitive risks. A growing part of our business involves cloud-based services available across the spectrum of computing devices. Our strategic vision is to compete and grow by building best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence (“AI”). At the same time, our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud and sometimes the user’s choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our cloud-based strategies. The Windows ecosystem must continue to evolve with this changing environment. We are undertaking cultural and organizational changes to drive accountability and eliminate obstacles to innovation. Our intelligent cloud and intelligent edge worldview is connected with the growth of the internet of things (“IoT”). Our success in the IoT will depend on the level of adoption of our offerings such as Microsoft Azure, Azure Stack, Azure IoT Edge, and Azure Sphere. We may not establish market share sufficient to achieve scale necessary to achieve our business objectives.

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

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

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

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We make significant investments in new products and services that may not achieve expected returns. We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows operating system, Microsoft 365, Office, Bing, Microsoft SQL Server, Windows Server, Microsoft Stores, Azure, Office 365, Xbox Live, Mixer, LinkedIn, and other cloud-based offerings. We also invest in the development and acquisition of a variety of hardware for productivity, communication, and entertainment including PCs, tablets, gaming devices, and HoloLens. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software and hardware products or upgrades, unfavorably affecting revenue. We may not achieve significant revenue from new product, service, and distribution channel investments for several years, if at all. New products and services may not be profitable, and even if they are profitable, operating margins for some new products and businesses will not be as high as the margins we have experienced historically. We may not get engagement in certain features, like Microsoft Stores, Microsoft Edge, and Bing, that drive post-license monetization opportunities. Our data handling practices across our products and services will continue to be under scrutiny and perceptions of mismanagement, driven by regulatory activity or negative public reaction to our practices or product experiences, which could negatively impact product and feature adoption, product design, and product quality.

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

Acquisitions, joint ventures, and strategic alliances may have an adverse effect on our business. We expect to continue making acquisitions and entering into joint ventures and strategic alliances as part of our long-term business strategy. In December 2016, we completed our acquisition of LinkedIn Corporation for $27.0 billion, and in October 2018, we completed our acquisition of GitHub, Inc. for $7.5 billion. These acquisitions and other transactions and arrangements involve significant challenges and risks, including that they do not advance our business strategy, that we get an unsatisfactory return on our investment, that we have difficulty integrating and retaining new employees, business systems, and technology, or that they distract management from our other businesses. If an arrangement fails to adequately anticipate changing circumstances and interests of a party, it may result in early termination or renegotiation of the arrangement. The success of these transactions and arrangements will depend in part on our ability to leverage them to enhance our existing products and services or develop compelling new ones. It may take longer than expected to realize the full benefits from these transactions and arrangements, such as increased revenue, enhanced efficiencies, or increased market share, or the benefits may ultimately be smaller than we expected. These events could adversely affect our operating results or financial condition.

If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings. We acquire other companies and intangible assets and may not realize all the economic benefit from those acquisitions, which could cause an impairment of goodwill or intangibles. We review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in our stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in industry segments in which we participate. We have in the past recorded, and may in the future be required to record a significant charge on our consolidated financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively affecting our results of operations. Our acquisition of LinkedIn resulted in a

significant increase in our goodwill and intangible asset balances.

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

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

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

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

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

Security of our information technology

Threats to IT security can take a variety of forms. Individual and groups of hackers and sophisticated organizations, including state-sponsored organizations or nation-states, continuously undertake attacks that pose threats to our customers and our IT. These actors may use a wide variety of methods, which may include developing and deploying malicious software or exploiting vulnerabilities in hardware, software, or other infrastructure in order to attack our products and services or gain access to our networks and datacenters, using social engineering techniques to induce our employees, users, partners, or customers to disclose passwords or other sensitive information or take other actions to gain access to our data or our users' or customers' data, or acting in a coordinated manner to launch distributed denial of service or other coordinated attacks. Inadequate account security practices may also result in unauthorized access to confidential data. For example, system administrators may fail to timely remove employee account access when no longer appropriate. Employees or third parties may intentionally compromise our or our users' security or systems, or reveal confidential information.

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Cyberthreats are constantly evolving, increasing the difficulty of detecting and successfully defending against them. We may have no current capability to detect certain vulnerabilities, which may allow them to persist in the environment over long periods of time. Cyberthreats can have cascading impacts that unfold with increasing speed across our internal networks and systems and those of our partners and customers. Breaches of our facilities, network, or data security could disrupt the security of our systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, result in product development delays, compromise confidential or technical business information harming our reputation or competitive position, result in theft or misuse of our intellectual property or other assets, require us to allocate more resources to improved technologies, or otherwise adversely affect our business.

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

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

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

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

The cost of these steps could reduce our operating margins. If we fail to do these things well, actual or perceived security vulnerabilities in our products and services, data corruption issues, or reduced performance could harm our reputation and lead customers to reduce or delay future purchases of products or subscriptions to services, or to use competing products or services. Customers may also spend more on protecting their existing computer systems from attack, which could delay adoption of additional products or services. Customers may fail to update their systems, continue to run software or operating systems we no longer support, or may fail timely to install or enable security patches. Any of these could adversely affect our reputation and revenue. Actual or perceived vulnerabilities may lead to claims against us. Our license agreements typically contain provisions that eliminate or limit our exposure to

liability, but there is no assurance these provisions will withstand legal challenges. At times, to achieve commercial objectives, we may enter into agreements with larger liability exposure to customers.

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

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

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

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

We may have excessive outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic, growth in services, and the complexity of our products and services demand more computing power. We spend substantial amounts to build, purchase, or lease datacenters and equipment and to upgrade our technology and network infrastructure to handle more traffic on our websites and in our datacenters. These demands continue to increase as we introduce new products and services and support the growth of existing services such as Bing, Exchange Online, Azure, Microsoft Account services, Office 365, OneDrive, SharePoint Online, Skype, Xbox Live, Outlook.com, and Microsoft Stores. We are rapidly growing our business of providing a platform and back-end hosting for services provided by third parties to their end users. Maintaining, securing, and expanding this infrastructure is expensive and complex. It requires that we maintain an Internet

connectivity infrastructure that is robust and reliable within competitive and regulatory constraints that continue to evolve. Inefficiencies or operational failures, including temporary or permanent loss of customer data or insufficient Internet connectivity, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, regulatory actions, damage to our reputation, and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

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

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

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

Government regulatory actions and court decisions such as these may result in fines, or hinder our ability to provide the benefits of our software to consumers and businesses, reducing the attractiveness of our products and the revenue that come from them. New competition law actions could be initiated, potentially using previous actions as precedent. 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.
- We are subject to a variety of ongoing commitments because of court or administrative orders, consent decrees, or other voluntary actions we have taken. If we fail to comply with these commitments, we may incur litigation costs and be subject to substantial fines or other remedial actions.
- Our ability to realize anticipated Windows 10 post-sale monetization opportunities may be limited.

Our global operations subject us to potential liability under anti-corruption, trade protection, and other laws and regulations. The Foreign Corrupt Practices Act and other anti-corruption laws and regulations ("Anti-Corruption Laws") prohibit corrupt payments by our employees, vendors, or agents. From time to time, we receive inquiries from authorities in the U.S. and elsewhere and reports from employees and others about our business activities outside the U.S. and our compliance with Anti-Corruption Laws. Specifically, we have been cooperating with authorities in the U.S. in connection with reports concerning our compliance with the Foreign Corrupt Practices Act in various countries. Most countries in which we operate also have competition laws that prohibit competitors from colluding or otherwise attempting to reduce competition between themselves. While we devote substantial resources to our global compliance programs and have implemented policies, training, and internal controls designed to reduce the risk of corrupt payments and collusive activity, our employees, vendors, or agents may violate our policies. Our failure to comply with Anti-Corruption Laws or competition laws could result in significant fines and penalties, criminal

sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation. Operations outside the U.S. may be affected by changes in trade protection laws, policies, and measures, sanctions, and other regulatory requirements affecting trade and investment. We may be subject to legal liability and reputational damage if we sell goods or services in violation of U.S. trade sanctions on countries such as Iran, North Korea, Cuba, Sudan, and Syria.

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

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

Laws and regulations relating to the handling of personal data may impede the adoption of our services or result in increased costs, legal claims, fines against us, or reputational damage. The growth of our Internet- and cloud-based services internationally relies increasingly on the movement of data across national boundaries. Legal requirements relating to the collection, storage, handling, and transfer of personal data continue to evolve. For example, the EU and the U.S. formally entered into a new framework in July 2016 that provides a mechanism for companies to transfer data from EU member states to the U.S. This framework, called the Privacy Shield, is intended to address shortcomings identified by the European Court of Justice in a predecessor mechanism. The Privacy Shield and other mechanisms are currently subject to challenges in European courts, which may lead to uncertainty about the legal basis for data transfers across the Atlantic. The Privacy Shield and other potential rules on the flow of data across borders could increase the cost and complexity of delivering our products and services in some markets. In May 2018, a new EU law governing data practices and privacy, the General Data Protection Regulation ("GDPR"), became effective. The law, which applies to all of our activities conducted from an establishment in the EU or related to products and services offered in the EU, imposes a range of new compliance obligations regarding the handling of personal data. Engineering efforts to build new capabilities to facilitate compliance with the law have entailed substantial expense and the diversion of engineering resources from other projects and may continue to do so. We might experience reduced demand for our offerings if we are unable to engineer products that meet our legal duties or help our customers meet their obligations under the GDPR or other data regulations, or if the changes we implement to comply with the GDPR make our offerings less attractive. The GDPR imposes significant new obligations and compliance with these obligations depends in part on how particular regulators apply and interpret them. If we fail to comply with the GDPR, or if regulators assert we have failed to comply with the GDPR, it may lead to regulatory enforcement actions, which can result in monetary penalties of up to 4% of worldwide revenue, private lawsuits, or reputational damage.

The Company's investment in gaining insights from data is becoming central to the value of the services we deliver to customers, to our operational efficiency and key opportunities in monetization, customer perceptions of quality, and operational efficiency. Our ability to use data in this way may be constrained by regulatory developments that impede

realizing the expected return from this investment. Ongoing legal reviews by regulators may result in burdensome or inconsistent requirements, including data sovereignty and localization requirements, affecting the location and movement of our customer and internal employee data as well as the management of that data. Compliance with applicable laws and regulations regarding personal data may require changes in services, business practices, or internal systems that result in increased costs, lower revenue, reduced efficiency, or greater difficulty in competing with foreign-based firms. Compliance with data regulations might limit our ability to innovate or offer certain features and functionality in some jurisdictions where we operate. Failure to comply with existing or new rules may result in significant penalties or orders to stop the alleged noncompliant activity, as well as negative publicity and diversion of management time and effort.

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

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

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. For example, compliance with the 2017 United States Tax Cuts and Jobs Act ("TCJA") may require the collection of information not regularly produced within the Company, the use of estimates in our consolidated financial statements, and the exercise of significant judgment in accounting for its provisions. As regulations and guidance evolve with respect to TCJA, and as we gather more information and perform more analysis, our results may differ from previous estimates and may materially affect our consolidated financial position.

We regularly are under audit by tax authorities in different jurisdictions. Although we believe that our provision for income taxes and our tax estimates are reasonable, tax authorities may disagree with certain positions we have taken. In addition, economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes favorably more difficult. We are currently under Internal Revenue Service audit for prior tax years, with the primary unresolved issues relating to transfer pricing. The final resolution of those audits, and other audits or litigation, may differ from the amounts recorded in our consolidated financial statements and may materially affect our financial results in the period or periods in which that determination is made.

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

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

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

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

Our global business exposes us to operational and economic risks. Our customers are located in over 200 countries and a significant part of our revenue comes from international sales. The global nature of our business creates operational and economic risks. Our results of operations may be affected by global, regional, and local economic developments, monetary policy, inflation, and recession, as well as political and military disputes. In addition, our international growth strategy includes certain markets, the developing nature of which presents several risks, including deterioration of social, political, labor, or economic conditions in a country or region, and difficulties in staffing and managing foreign operations. Emerging nationalist trends in specific countries may significantly alter the trade environment. Changes to trade policy or agreements as a result of populism, protectionism, or economic nationalism may result in higher tariffs, local sourcing initiatives, or other developments that make it more difficult to sell our products in foreign countries. Disruptions of these kinds in developed or emerging markets could negatively impact demand for our products and services or increase operating costs. Although we hedge a portion of our international currency exposure, significant fluctuations in foreign exchange rates between the U.S. dollar and foreign currencies may adversely affect our revenue.

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

Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may cause supply chain disruptions for hardware manufacturers. Geopolitical change may result in changing regulatory requirements that could impact our operating strategies, access to global markets, hiring, and profitability. Geopolitical instability may lead to sanctions and impact our ability to do business in some markets or with some public-sector customers. Any of these changes may negatively impact our revenues.

The long-term effects of climate change on the global economy or the IT industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy or other natural resources

may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services.

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

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

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

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

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

The development of the IoT presents security, privacy, and execution risks. To support the growth of the intelligent cloud and the intelligent edge, we are developing products, services, and technologies to power the IoT, a network of distributed and interconnected devices employing sensors, data, and computing capabilities including AI. The IoT's great potential also carries substantial risks. IoT products and services may contain defects in design, manufacture, or operation, that make them insecure or ineffective for their intended purposes. An IoT solution has multiple layers of hardware, sensors, processors, software, and firmware, several of which we may not develop or control. Each layer, including the weakest layer, can impact the security of the whole system. Many IoT devices have limited interfaces and ability to be updated or patched. IoT solutions may collect large amounts of data, and our handling of IoT data may not satisfy customers or regulatory requirements. IoT scenarios may increasingly affect personal health and safety. If IoT solutions that include our technologies do not work as intended, violate the law, or harm individuals or businesses, we may be subject to legal claims or enforcement actions. These risks, if realized, may increase our costs, damage our reputation or brands, or negatively impact our revenues or margins.

Issues in the use of AI in our offerings may result in reputational harm or liability. We are building AI into many of our offerings and we expect this element of our business to grow. We envision a future in which AI operating in our devices, applications, and the cloud helps our customers be more productive in their work and personal lives. As with many disruptive innovations, AI presents risks and challenges that could affect its adoption, and therefore our business. AI algorithms may be flawed. Datasets may be insufficient or contain biased information. Inappropriate or controversial data practices by Microsoft or others could impair the acceptance of AI solutions. These deficiencies could undermine the decisions, predictions, or analysis AI applications produce, subjecting us to competitive harm, legal liability, and brand or reputational harm. Some AI scenarios present ethical issues. If we enable or offer AI solutions that are controversial because of their impact on human rights, privacy, employment, or other social issues, we may experience brand or reputational harm.

If our reputation or our brands are damaged, our business and operating results may be harmed. Our reputation and brands are globally recognized and are important to our business. Our reputation and brands affect our ability to attract

and retain consumer, business, and public-sector customers. There are numerous ways our reputation or brands could be damaged. These include product safety or quality issues, or our environmental impact, supply chain practices, or human rights record. We may experience backlash from customers, government entities, advocacy groups, employees, and other stakeholders that disagree with our product offering decisions or public policy positions. Damage to our reputation or our brands may occur from, among other things:

- The introduction of new features, products, services, or terms of service that customers, users, or partners do not like.
- Public scrutiny of our decisions regarding user privacy, data practices, or content.
- Data security breaches, compliance failures, or actions of partners or individual employees.

The proliferation of social media may increase the likelihood, speed, and magnitude of negative brand events. If our brands or reputation are damaged, it could negatively impact our revenues or margins, or ability to attract the most highly qualified employees.

PART II

Item 2

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

UNREGISTERED SALE OF EQUITY SECURITIES

In connection with our acquisition of GitHub, Inc. on October 25, 2018, we issued 52,695,909 shares of Microsoft common stock to certain holders of capital stock of GitHub. The offer and sale of the shares were not registered under the Securities Act and were made in reliance upon the exemption from registration under Section 4(a)(2) of the Securities Act for an issuance not involving a public offering.

DIVIDENDS AND SHARE REPURCHASES

Refer to Note 15 – Stockholders' Equity of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion regarding dividends and share repurchases. Following are our monthly stock repurchases for the second quarter of fiscal year 2019:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs
				(in millions)
October 1, 2018 – October 31, 2018	13,825,939	$107.58	13,825,939	$ 24,113
November 1, 2018 – November 30, 2018	31,471,816	106.45	31,471,816	20,762
December 1, 2018 – December 31, 2018	12,047,602	104.79	12,047,602	19,500
	57,345,357		57,345,357	

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

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Item 6

ITEM 6. EXHIBITS

15.1	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

*Furnished, not filed

Items 3, 4, and 5 are not applicable and have been omitted.

SIGNATURE

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

MICROSOFT CORPORATION

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

Chief Accounting Officer (Duly Authorized Officer)

January 30, 2019

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