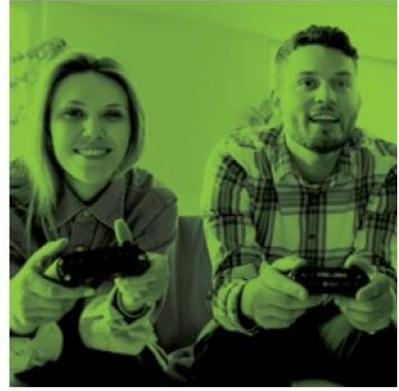


# Our Mission

Empower every person and every organization on the planet to achieve more.



Dear shareholders, customers, partners and colleagues:

It's been a remarkable year for all of us at Microsoft, a year of change and opportunity for our company, our industry and the world.

We as a company stand for deeply understanding the needs of customers, translating that understanding into products that people love and ultimately into the success our customers have with our products. It's that last part that is our key motivation. The entire Microsoft team is inspired to bring their best ideas and efforts every day to build products people love, and to advance our mission to **empower every person and every organization on the planet to achieve more**. And we're seeing the impact.

We sharpened our focus this past fiscal year, prioritizing our talent and investments in areas where we have differentiation and potential for growth. We executed with financial discipline, with revenue of \$93.6 billion, \$60.5 billion of gross margin, \$18.2 billion in operating income and \$12.2 billion in net income. And we significantly increased our total cash return to shareholders by nearly 50 percent to \$23.3 billion.

We also made key decisions that are moving us forward as the company that builds best-in-class platforms and productivity services for our mobile-first, cloud-first world.

- We launched Windows 10 as a service that unites your experience across a wide range of devices with innovations that increase productivity and flexibility while remaining familiar.
- Surface is proving that consumers and businesses alike want a tablet that can replace their laptop. We achieved \$3.6 billion in Surface revenue – equally gratifying is the fact that Surface won fans while also creating a new hardware category.
- We restructured our phone business, as we aligned our first-party hardware portfolio into the larger Windows ecosystem. Going forward we will focus on building premium, flagship phones for Windows fans and commercial customers.
- We delivered Office everywhere on all devices, and Office 365 consumer subscriptions grew to more than 15 million, adding nearly 10 million subscribers in the fiscal year. Commercial customers are rapidly adopting this service with seats growing by 74 percent.
- Azure cloud platform revenue and compute usage increased by over 100 percent in the fourth quarter year over year.
- We are gaining ground in business process applications with triple-digit growth of the Dynamics CRM Online installed base and the overall Dynamics business growing revenue by double digits.
- We delivered innovative new cloud services at an increasing pace spanning enterprise mobility, big data, cloud infrastructure and application developer services.

In this year's letter, I want to look forward and paint a picture of how we're building on this momentum while also reflecting on what we've learned.

**Empowerment.** Microsoft, since its founding, has stood for individual and organizational empowerment. What's different about our company when compared with the industry is that we make things that help other people make things. We also help them make things happen. We are well poised to ignite a new revolution in which digital technologies democratize access to people across economic strata, organizations of all sizes, entrepreneurs, researchers and students everywhere. This is empowerment. To deliver on this promise of empowerment, we've galvanized around three interconnected ambitions that will, in turn, drive our segment financial reporting this fiscal year.

**1) Reinvent productivity and business processes.** We are helping customers be even more effective with their individual time, while bringing together the power of teams and entire organizations to drive business outcomes and success. Time is quickly becoming our scarcest commodity, and people and organizations need the right tools and services that help them achieve increasingly complex and challenging outcomes more quickly than ever.

We are building an array of productivity, communications, collaboration and business process applications so that they are optimized for what our users want to achieve rather than being bound to any current product category definitions. We let you pick up any device and create, collaborate, communicate or do business using our cloud services. We enable you to complete your sales order by connecting seamlessly to CRM data within Outlook. We enable you to co-author in real time a student paper with a classmate or an RFP response with colleagues across your organization. We empower transparent communications and discovery of enterprise knowledge using tools such as Yammer, Delve and Power BI. Skype and Skype for Business enable you to have effective meetings with customers, partners and colleagues anywhere, anytime.

Here is a case in point. London's Metro Bank is reinventing the way banking works. Metro colleagues guide customers through important financial decisions using Dynamics CRM Online, Office 365, Power BI and Skype for Business. Customers like Metro are proving that we are at the dawn of a new generation, one with productivity and business process systems that fundamentally changes the nature of work, and more importantly drives superior business outcomes.

Looking ahead, we're poised for new growth given our bold ambition in this space. With Office 2016 and Office 365, we will continue to enrich the features and capabilities to help people create and communicate. As an example, many Office 365 customers will now get rich new voice capabilities with Skype for Business and other new features that have enabled us to expand our market opportunity for Office 365 by more than \$50 billion. The CRM and ERP markets combined are over \$60 billion, and represent a massive opportunity for reinvention as they shift to the cloud and mobile experiences.

**2) Build the intelligent cloud platform.** Microsoft is building a cloud platform that enables the world's applications to become intelligent using the next-generation infrastructure, data and developer services.

We are unique in that we are the only company building out a hyper-scale public cloud while also meeting customer needs for private cloud and hybrid solutions. The Azure cloud platform is now available in 140 countries with over 20 datacenter regions, more than any other public cloud. We are the first multinational company to operate a public cloud in China. Even as organizations transition to the cloud, we continue to see impressive growth in our server business with Windows Server, System Center Server and SQL Server. Our servers are the leading edge of this intelligent cloud, and this is important because there are going to be many legitimate reasons for people wanting digital sovereignty. We believe this is the future of true distributed computing infrastructure, designed to meet the needs and complexities of the real world.

Microsoft Enterprise Mobility had a breakout year, and now more than 17,000 customers are using the service. EMS delivers infrastructure for enterprises of all sizes to manage and secure all of their identities, applications, data and devices. In doing so, EMS enables a new way for organizations to work in a world where they are increasingly mobile and using SaaS services.

We are helping transform businesses through the use of data. Cortana Analytics Suite provides customers and application developers with a fully managed big data and analytics suite that transforms data into intelligent action. These capabilities are being used by customers across the full spectrum of industries throughout the economy. And we are capitalizing on the advent of the Internet of Things and the associated changes in business models that require increasingly advanced cloud data and analytics capabilities.

We made tremendous progress in our developer engagement this past year by delivering new innovative services to developers across all device platforms and also opening our technology to create more participation from open source communities. Visual Studio Online now provides a leading set of services for modern development.

I am excited about the growth opportunities ahead. We've broadened our addressable market by building and acquiring technologies in key growth categories like security, data and analytics, while also delivering greater integration and support for Linux and open source technologies such as Docker containers and Hadoop. Security is a key priority for our enterprise customers and represents a \$30 billion market opportunity. Likewise, business intelligence and analytics is another rapidly growing market for us with an opportunity of more than \$15 billion. We are expanding our datacenter presence to India and Canada, and will evaluate future expansion opportunities as well. We also have major new releases planned across Windows Server and SQL Server in the coming year that will provide continued opportunity for growth and include innovations developed in our public cloud to empower customers' IT and developer teams to achieve more.

**3) Create more personal computing.** Our ambition is to make your Windows experience, whether at home or at work, more natural, more mobile, and more trusted. Whether using our devices for productivity, gaming, browsing or anything else, we want to move customers from needing, to choosing, to loving Windows.

With the launch of Windows 10, we're just at the start of a new era of computing that's more personal, focused on the mobility of human experiences across devices. Innovations such as Continuum on Lumia phones running Windows 10, for example, enable you to simply take your phone and attach it to a screen and keyboard providing robust productivity experiences so your phone can function as a laptop. Windows 10 is more personal and more productive with Cortana, Office and universal apps. Windows 10 is delivering truly breakthrough new experiences, like inking on our new browser, Microsoft Edge, and gaming across Xbox and PCs. It also opens up entirely new device categories such as HoloLens. Security and trust are essential. Windows 10 is safe, secure and always up to date. And it provides a single device management platform across all devices, from phones, to laptops, to Internet of Things devices.

We're excited and appreciative to see the enthusiastic response to Windows 10 with more than 110 million devices already active with the latest Windows.

Going forward, I believe we will broaden our economic opportunity and return Windows to growth. This holiday, we will see the widest range ever of Windows devices, including hundreds of new hardware designs from our partners. With Surface, our vision that customers would want a tablet that can replace a laptop has added to the Windows ecosystem and created new opportunities for our partners to innovate. We'll also grow through monetization opportunities across the commercial and consumer spaces. In the enterprise, customers will continue to value our unparalleled management, security and servicing capabilities. And for consumers, Windows 10 creates monetization opportunities with Store, search and gaming.

**New growth.** With all of this new innovation hitting the market, we are on track to reach two important goals for fiscal year 2018: a commercial cloud revenue annual run rate of \$20 billion and 1 billion Windows 10 active devices per month.

Our approach to growth is simple – we'll make products and services that are differentiated in markets that are large and growing and pioneer new categories. We'll continue the transition from a transactional relationship with customers to one that recognizes the more consistent, lifetime value of a customer. Each of our three ambitions positions Microsoft to increase the lifetime value of our customers and win new customers in every part of the world. We work hard to earn the trust you've shown with your investment. Our past success and ongoing execution make it possible for us to deliver the financial performance, strength of balance sheet and return of capital today. It's our passion for innovation and ambition in rapidly growing markets is what has the potential to deliver new value long into the future.

**Culture.** Simply stated, I want Microsoft to be the greatest place to work for smart people who are hungry to make a difference. It's been said that culture is the widening of the mind and of the spirit. We spend far too much of our lives at work not to find deep meaning in what we do. The broad aperture of our mission and appetite for growth invites diversity in all delineations so all employees can uniquely contribute and bring their best every day. When people are doing what they love and pursuing a mission they believe in with a growth mindset, I know both great innovation and growth will happen.

When I first started in my new role last year I told employees it was time for us to rediscover our soul – what makes us unique. In "The Soul of a New Machine," author Tracy Kidder shows us that technology is nothing more than the collective soul of those who built it. The technology is fascinating, but even more fascinating is the profound obsession of its designers. In the year ahead we will continue to ask ourselves what are the challenges mankind faces, how can technology help, and what is the contribution of Microsoft? We can clearly see that there's a transformation underway in our business and renewed spirit in our hallways. We are just starting to get a glimpse of how Microsoft technology empowers customers to succeed and make their own difference in the world. We are eager to see what we can do in the year ahead to drive greater growth and greater impact in our world.

Satya Nadella  
Chief Executive Officer  
October 19, 2015

# SELECTED FINANCIAL DATA, QUARTERLY STOCK PRICE INFORMATION, ISSUER PURCHASES OF EQUITY SECURITIES, DIVIDENDS, AND STOCK PERFORMANCE

## FINANCIAL HIGHLIGHTS

(In millions, except per share data)

Year Ended June 30,	2015	2014 <sup>(b)</sup>	2013	2012	2011
Revenue	\$ 93,580	\$ 86,833	\$ 77,849	\$ 73,723	\$ 69,943
Gross margin	\$ 60,542	\$ 59,755	\$ 57,464	\$ 56,193	\$ 54,366
Operating income	\$ 18,161 <sup>(a)</sup>	\$ 27,759	\$ 26,764 <sup>(c)</sup>	\$ 21,763 <sup>(d)</sup>	\$ 27,161
Net income	\$ 12,193 <sup>(a)</sup>	\$ 22,074	\$ 21,863 <sup>(c)</sup>	\$ 16,978 <sup>(d)</sup>	\$ 23,150
Diluted earnings per share	\$ 1.48 <sup>(a)</sup>	\$ 2.63	\$ 2.58 <sup>(c)</sup>	\$ 2.00 <sup>(d)</sup>	\$ 2.69
Cash dividends declared per share	\$ 1.24	\$ 1.12	\$ 0.92	\$ 0.80	\$ 0.64
Cash, cash equivalents, and short-term investments	\$ 96,526	\$ 85,709	\$ 77,022	\$ 63,040	\$ 52,772
Total assets	\$ 176,223	\$ 172,384	\$ 142,431	\$ 121,271	\$ 108,704
Long-term obligations	\$ 46,282	\$ 36,975	\$ 26,070	\$ 22,220	\$ 22,847
Stockholders' equity	\$ 80,083	\$ 89,784	\$ 78,944	\$ 66,363	\$ 57,083

- (a) Includes \$7.5 billion of goodwill and asset impairment charges related to Phone Hardware, and \$2.5 billion of integration and restructuring expenses, primarily costs associated with our restructuring plans, which decreased fiscal year 2015 operating income and net income by \$10.0 billion and diluted earnings per share ("EPS") by \$1.15.
- (b) On April 25, 2014, we acquired substantially all of NDS. NDS has been included in our consolidated results of operations starting on the acquisition date.
- (c) Includes a charge related to a fine imposed by the European Commission in March 2013 which decreased operating income and net income by \$733 million (€561 million) and diluted EPS by \$0.09. Also includes a charge for Surface RT inventory adjustments recorded in the fourth quarter of fiscal year 2013, which decreased operating income by \$900 million, net income by \$596 million, and diluted EPS by \$0.07.
- (d) Includes a goodwill impairment charge related to our previous Online Services Division business segment (related to Devices and Consumer Other under our current segment structure) which decreased operating income and net income by \$6.2 billion and diluted EPS by \$0.73.

## QUARTERLY STOCK PRICE

Our common stock is traded on the NASDAQ Stock Market under the symbol MSFT. On July 27, 2015, there were 109,479 registered holders of record of our common stock. The high and low common stock sales prices per share were as follows:

Quarter Ended	September 30	December 31	March 31	June 30	Fiscal Year
<b>Fiscal Year 2015</b>					
High	\$ 47.57	\$ 50.05	\$ 47.91	\$ 49.54	\$ 50.05
Low	\$ 41.05	\$ 42.10	\$ 40.23	\$ 40.12	\$ 40.12
<b>Fiscal Year 2014</b>					
High	\$ 36.43	\$ 38.98	\$ 41.50	\$ 42.29	\$ 42.29
Low	\$ 30.84	\$ 32.80	\$ 34.63	\$ 38.51	\$ 30.84

## SHARE REPURCHASES AND DIVIDENDS

### Share Repurchases

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to \$40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. This share repurchase program replaced the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013. As of June 30, 2015, \$21.9 billion remained of our \$40.0 billion share repurchase program. All repurchases were made using cash resources.

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

(In millions)	Shares	Amount	Shares	Amount	Shares	Amount
<b>Year Ended June 30,</b>		<b>2015</b>		<b>2014 <sup>(a)</sup></b>		<b>2013</b>
First quarter	<b>43</b>	<b>\$ 2,000</b>	47	\$ 1,500	33	\$ 1,000
Second quarter	<b>43</b>	<b>2,000</b>	53	2,000	58	1,607
Third quarter	<b>116</b>	<b>5,000</b>	47	1,791	36	1,000
Fourth quarter	<b>93</b>	<b>4,209</b>	28	1,118	31	1,000
Total	<b>295</b>	<b>\$ 13,209</b>	175	\$ 6,409	158	\$ 4,607

(a) Of the 175 million shares repurchased in fiscal year 2014, 128 million shares were repurchased for \$4.9 billion under the share repurchase program approved by our Board of Directors on September 16, 2013 and 47 million shares were repurchased for \$1.5 billion under the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013.

The above table excludes shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards.

## Dividends

In fiscal year 2015, our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(In millions)	
<b>September 16, 2014</b>	<b>\$ 0.31</b>	<b>November 20, 2014</b>	<b>\$ 2,547</b>	<b>December 11, 2014</b>
<b>December 3, 2014</b>	<b>\$ 0.31</b>	<b>February 19, 2015</b>	<b>\$ 2,532</b>	<b>March 12, 2015</b>
<b>March 10, 2015</b>	<b>\$ 0.31</b>	<b>May 21, 2015</b>	<b>\$ 2,496</b>	<b>June 11, 2015</b>
<b>June 9, 2015</b>	<b>\$ 0.31</b>	<b>August 20, 2015</b>	<b>\$ 2,488</b>	<b>September 10, 2015</b>

The dividend declared on June 9, 2015 will be paid after the filing date of our Form 10-K and was included in other current liabilities as of June 30, 2015.

In fiscal year 2014, our Board of Directors declared the following dividends:

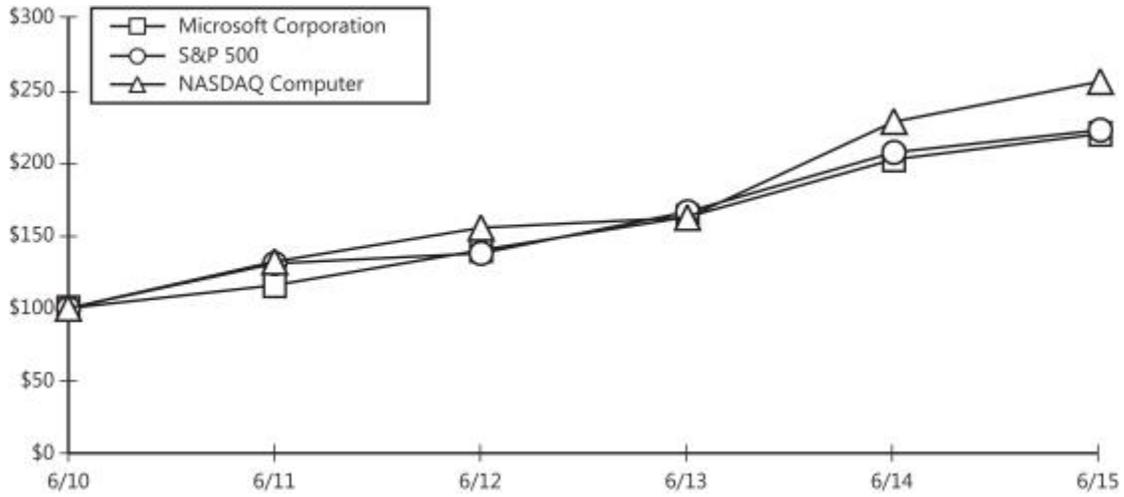
Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(In millions)	
September 16, 2013	\$ 0.28	November 21, 2013	\$ 2,332	December 12, 2013
November 19, 2013	\$ 0.28	February 20, 2014	\$ 2,322	March 13, 2014
March 11, 2014	\$ 0.28	May 15, 2014	\$ 2,309	June 12, 2014
June 10, 2014	\$ 0.28	August 21, 2014	\$ 2,307	September 11, 2014

The dividend declared on June 10, 2014 was included in other current liabilities as of June 30, 2014.

STOCK PERFORMANCE

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among Microsoft Corporation, the S&P 500 Index  
and the NASDAQ Computer Index



	<u>6/10</u>	<u>6/11</u>	<u>6/12</u>	<u>6/13</u>	<u>6/14</u>	<u>6/15</u>
Microsoft Corporation	100.00	115.72	139.87	162.77	202.28	219.82
S&P 500	100.00	130.69	137.81	166.20	207.10	222.47
NASDAQ Computer	100.00	132.06	155.24	162.07	228.24	255.75

\* \$100 invested on 6/30/10 in stock or index, including reinvestment of dividends.

## **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: “Business,” “Management’s Discussion and Analysis,” and “Risk Factors.” These forward-looking statements generally are identified by the words “believe,” “project,” “expect,” “anticipate,” “estimate,” “intend,” “strategy,” “future,” “opportunity,” “plan,” “may,” “should,” “will,” “would,” “will be,” “will continue,” “will likely result,” and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in “Risk Factors” and “Management’s Discussion and Analysis” in our fiscal year 2015 Form 10-K. We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

## **BUSINESS DESCRIPTION**

### GENERAL

#### **Our vision**

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. Our strategy is to build best-in-class platforms and productivity services for a mobile-first, cloud-first world.

The mobile-first, cloud-first world is transforming the way individuals and organizations use and interact with technology. Our worldview for mobile-first is not about the mobility of devices; it is centered on the mobility of experiences that, in turn, are orchestrated by the cloud. Cloud computing and storage solutions provide users and enterprises with various capabilities to store and process their data in third-party data centers. Mobility encompasses the rich collection of data, applications, and services that accompany our customers as they move from setting to setting in their lives. We are transforming our businesses to enable Microsoft to lead the direction of this transformation, and enable our customers and partners to thrive in this evolving world.

#### **What we offer**

Founded in 1975, we operate worldwide and have offices in more than 100 countries. We develop, license, and support a wide range of software products, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people’s lives. We offer an array of services, including cloud-based services, to consumers and businesses. We design, manufacture, and sell devices that integrate with our cloud-based services, and we deliver relevant online advertising to a global audience.

Our products include operating systems for computing devices, servers, phones, and other intelligent devices; server applications for distributed computing environments; cross-device productivity applications; business solution applications; desktop and server management tools; software development tools; video games; and online advertising. We also design and sell hardware including PCs, tablets, gaming and entertainment consoles, phones, other intelligent devices, and related accessories. We offer cloud-based solutions that provide customers with software, services, platforms, and content. We also provide consulting and product and solution support services, and we train and certify computer system integrators and developers.

#### **The ambitions that drive us**

To carry out our strategy, our research and development efforts focus on three interconnected ambitions:

- Reinvent productivity and business processes.
- Build the intelligent cloud platform.
- Create more personal computing.

#### *Reinvent productivity and business processes*

We believe we can significantly enhance the lives of our customers using our broad portfolio of communication, productivity, and information services that spans devices and platforms. Productivity will be the first and foremost objective, to enable people to meet and collaborate more easily, and to effectively express ideas in new ways. We will

design applications as dual-use with the intelligence to partition data between work and life while respecting each person's privacy choices. The foundation for these efforts will rest on advancing our leading productivity, collaboration, and business process tools including Skype, OneDrive, OneNote, Outlook, Word, Excel, PowerPoint, Bing, and Dynamics. With Office 365, we provide these familiar industry-leading productivity and business process tools as cloud services, enabling access from anywhere and any device. This creates an opportunity to reach new customers, and expand the usage of our services by our existing customers.

We see opportunity in combining our offerings in new ways that are more contextual and personal, while ensuring people, rather than their devices, remain at the center of the digital experience. We will offer our services across ecosystems and devices outside our own. As people move from device to device, so will their content and the richness of their services. We are engineering our applications so users can find, try, and buy them in friction-free ways.

### *Build the intelligent cloud platform*

In deploying technology that advances business strategy, enterprises decide what solutions will make employees more productive, collaborative, and satisfied, and connect with customers in new and compelling ways. They work to unlock business insights from a world of data. To achieve these objectives, increasingly businesses look to leverage the benefits of the cloud. Helping businesses move to the cloud is one of our largest opportunities, and we believe we work from a position of strength.

The shift to the cloud is driven by three important economies of scale: larger datacenters can deploy computational resources at significantly lower cost per unit than smaller ones; larger datacenters can coordinate and aggregate diverse customer, geographic, and application demand patterns, improving the utilization of computing, storage, and network resources; and multi-tenancy lowers application maintenance labor costs for large public clouds. As one of the largest providers of cloud computing at scale, we are well-positioned to help businesses move to the cloud so that businesses can focus on innovation while leaving non-differentiating activities to reliable and cost-effective providers like Microsoft.

With Azure, we are one of very few cloud vendors that run at a scale that meets the needs of businesses of all sizes and complexities. We believe the combination of Azure and Windows Server makes us the only company with a public, private, and hybrid cloud platform that can power modern business. We are working to enhance the return on information technology ("IT") investment by enabling enterprises to combine their existing datacenters and our public cloud into a single cohesive infrastructure. Businesses can deploy applications in their own datacenter, a partner's datacenter, or in our datacenters with common security, management, and administration across all environments, with the flexibility and scale they want.

We enable organizations to securely adopt software-as-a-service applications (both our own and third-party) and integrate them with their existing security and management infrastructure. We will continue to innovate with higher-level services including identity and directory services that manage employee corporate identity and manage and secure corporate information accessed and stored across a growing number of devices, rich data storage and analytics services, machine learning services, media services, web and mobile backend services, and developer productivity services. To foster a rich developer ecosystem, our digital work and life experiences will also be extensible, enabling customers and partners to further customize and enhance our solutions, achieving even more value. This strategy requires continuing investment in datacenters and other infrastructure to support our devices and services.

### *Create more personal computing*

Windows 10 is the cornerstone of our ambition to usher in an era of more personal computing. We see the launch of Windows 10 in July 2015 as a critical, transformative moment for the Company because we will move from an operating system that runs on a PC to a service that can power the full spectrum of devices in our customers' lives. We developed Windows 10 not only to be familiar to our users, but more safe and secure, and always up-to-date. We believe Windows 10 is more personal and productive, working seamlessly with functionality such as Cortana, Office, Continuum, and universal applications. We designed Windows 10 to foster innovation – from us, our partners and developers – through experiences such as our new browser Microsoft Edge, across the range of existing devices, and into entirely new device categories.

Our ambition for Windows 10 is to broaden our economic opportunity through three key levers: an original equipment manufacturer (“OEM”) ecosystem that creates exciting new hardware designs for Windows 10; our own commitment to the health and profitability of our first-party premium device portfolio; and monetization opportunities such as services, subscriptions, gaming, and search. Our OEM partners are investing in an extensive portfolio of hardware designs and configurations as they ready for Windows 10. By December 2015, we anticipate the widest range of Windows hardware ever to be available.

With the launch of Windows 10, we are realizing our vision of a single, unified Windows operating system on which developers and OEMs can contribute to a thriving Windows ecosystem. We invest heavily to make Windows the most secure, manageable, and capable operating system for the needs of a modern workforce. We are working to create a broad developer opportunity by unifying the installed base to Windows 10 through upgrades and ongoing updates, and by enabling universal Windows applications to run across all device targets. As part of our strategic objectives, we are committed to designing and marketing first-party devices to help drive innovation, create new categories, and stimulate demand in the Windows ecosystem, including across PCs, phones, tablets, consoles, wearables, large multi-touch displays, and new categories such as the HoloLens holographic computing platform. We are developing new input/output methods like speech, pen, gesture, and augmented reality holograms to power more personal computing experiences with Windows 10.

### *Our future opportunity*

There are several distinct areas of technology that we aim to drive forward. Our goal is to lead the industry in these areas over the long-term, which we expect will translate to sustained growth. We are investing significant resources in:

- Delivering new productivity, entertainment, and business processes to improve how people communicate, collaborate, learn, work, play, and interact with one another.
- Establishing the Windows platform across the PC, tablet, phone, server, other devices, and the cloud to drive a thriving ecosystem of developers, unify the cross-device user experience, and increase agility when bringing new advances to market.
- Building and running cloud-based services in ways that unleash new experiences and opportunities for businesses and individuals.
- Developing new devices that have increasingly natural ways to interact with them, including speech, pen, gesture, and augmented reality holograms.
- Applying machine learning to make technology more intuitive and able to act on our behalf, instead of at our command.

We believe the breadth of our products and services portfolio, our large global partner and customer base, our growing ecosystem, and our ongoing investment in innovation position us to be a leader in these areas and differentiate ourselves from competitors.

## OPERATING SEGMENTS

We operate our business in six segments. Our Devices and Consumer (“D&C”) segments include D&C Licensing, Computing and Gaming Hardware, Phone Hardware, and D&C Other. Our Commercial segments include Commercial Licensing and Commercial Other. Our segments provide management with a comprehensive financial view of our key businesses. The segments enable the alignment of strategies and objectives across the development, sales, marketing, and services organizations, and they provide a framework for timely and rational allocation of development, sales, marketing, and services resources within businesses. In June 2015, we announced a change in organizational structure as part of our transformation in the mobile-first, cloud-first world. As we evolve how we allocate resources and analyze performance in the new structure, it is possible that our segments may change.

On April 25, 2014, we acquired substantially all of Nokia Corporation’s (“Nokia”) Devices and Services Business (“NDS”). We report the financial performance of the acquired business in our Phone Hardware segment. Prior to the acquisition of NDS, financial results associated with our joint strategic initiatives with Nokia were reflected in our D&C Licensing segment. The contractual relationship with Nokia related to those initiatives ended in conjunction with the acquisition.

Additional information on our operating segments and geographic and product information is contained in Note 22 – Segment Information and Geographic Data of the Notes to Financial Statements.

### **Devices and Consumer**

Our D&C segments develop, manufacture, market, and support products and services designed to entertain and connect people, increase personal productivity, help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. Our D&C segments are made up of D&C Licensing, Computing and Gaming Hardware, Phone Hardware, and D&C Other.

### *D&C Licensing*

The principal products and services provided by the D&C Licensing segment are: Windows, including all OEM licensing (“Windows OEM”) and other non-volume licensing and academic volume licensing of the Windows operating system and related software; non-volume licensing of Microsoft Office, comprising the core Office product set, for consumers (“Office Consumer”); Windows Phone operating system, including related patent licensing; and certain other patent licensing revenue.

The Windows operating system is designed to deliver a more personal computing experience for users by enabling consistency of experience, applications, and information across their devices.

Windows revenue is impacted significantly by the number of Windows operating system licenses purchased by OEMs, which they pre-install on the devices they sell. In addition to computing device market volume, Windows revenue is impacted by:

- The mix of computing devices based on form factor and screen size.
- Differences in device market demand between developed markets and emerging markets.
- Attachment of Windows to devices shipped.
- Customer mix between consumer, small- and medium-sized businesses, and large enterprises.
- Changes in inventory levels in the OEM channel.
- Pricing changes and promotions, pricing variation that occurs when the mix of devices manufactured shifts from local and regional system builders to large, multinational OEMs, and different pricing of Windows versions licensed.
- Piracy.

The versions of Office included in our D&C Licensing segment are designed to increase personal productivity through a range of programs, services, and software solutions. Growth depends on our ability to add value to the core product set and to continue to expand our product offerings in other areas such as content management and collaboration. Office Consumer revenue is impacted by sales to customers that buy Office with their new devices and by product launches, as well as the transition to Office 365 Consumer, our subscription-based cloud service that provides access to Office plus other productivity services. Office 365 Consumer revenue is included in our D&C Other segment.

The Windows Phone operating system is designed to bring users closer to the people, applications, and content they need. As noted above, prior to our acquisition of NDS, Microsoft and Nokia jointly created new mobile products and services and extended established products and services to new markets through a strategic alliance. Windows Phone revenue associated with this contractual relationship was reflected in D&C Licensing. Windows Phone revenue also includes revenue from licensing mobile-related patents.

### Competition

The Windows operating system faces competition from various software products and from alternative platforms and devices, mainly from Apple and Google. We believe Windows competes effectively by giving customers choice, value, flexibility, security, an easy-to-use interface, compatibility with a broad range of hardware and software applications, including those that enable productivity, and the largest support network for any operating system.

Competitors to the versions of Office included in D&C Licensing include global application vendors such as Apple and Google, numerous web-based and mobile application competitors, and local application developers in Asia and Europe. Apple distributes versions of its pre-installed application software, such as email, note-taking, and calendar products, through its PCs, tablets, and phones. Google provides a hosted messaging and productivity suite. Web-based offerings competing with individual applications can also position themselves as alternatives to our products. We believe our products compete effectively based on our strategy of providing powerful, flexible, secure, and easy to use solutions that work across a variety of devices.

Windows Phone operating system faces competition from iOS, Android, and Blackberry operating systems. Windows Phone competes based on differentiated user interface, personalized applications, compatibility with Windows PCs and tablets, and other unique capabilities.

### *Computing and Gaming Hardware*

The principal products and services provided by the Computing and Gaming Hardware segment are: Xbox gaming and entertainment consoles and accessories, second-party and third-party video game royalties, and Xbox Live subscriptions (“Xbox Platform”); Surface devices and accessories (“Surface”); and Microsoft PC accessories.

The Xbox Platform is designed to provide a unique variety of entertainment choices through the use of our devices, peripherals, content, and online services. We released Xbox 360 and Xbox One in November 2005 and November 2013, respectively.

Surface is designed to help organizations, students, and consumers to be more productive. Our latest Surface devices, the Surface Pro 3 and Surface 3, were released in June 2014 and May 2015, respectively.

### Competition

Our Xbox Platform competes with console platforms from Sony and Nintendo, both of which have a large, established base of customers. The lifecycle for gaming and entertainment consoles averages five to ten years. Nintendo released their latest generation console in November 2012. Sony released their latest generation console in November 2013.

We believe the success of gaming and entertainment consoles is determined by the availability of games for the console, providing exclusive game content that gamers seek, the computational power and reliability of the console, and the ability to create new experiences via online services, downloadable content, and peripherals. In addition to Sony and Nintendo, we compete with other providers of entertainment services through online marketplaces. We believe the Xbox Platform is effectively positioned against competitive products and services based on significant innovation in hardware architecture, user interface, developer tools, online gaming and entertainment services, and continued strong exclusive content from our own game franchises as well as other digital content offerings.

Surface devices face competition from Apple, as well as other computer, tablet, and hardware manufacturers, many of which are also current or potential partners and customers.

### *Phone Hardware*

The principal products provided by the Phone Hardware segment are Lumia phones and other non-Lumia phones, which we began manufacturing and selling with the acquisition of NDS on April 25, 2014. Our Lumia phones run Windows and are designed to enable people and organizations to connect to the people and content that matter most, using integrated Microsoft services such as Outlook, OneDrive, Skype, and Office.

### Competition

Our phones face competition primarily from Apple, Samsung, and many other mobile device manufacturers running the Android operating system, and offer a unique combination of high-quality industrial design and innovative imaging technologies across various price points.

### *D&C Other*

The principal products and services provided by the D&C Other segment are: Resale, consisting of transactions in our Windows Store and Xbox marketplace; search advertising; display advertising; Office 365 Consumer, comprising Office 365 Home and Office 365 Personal; Studios, comprising first-party video games; Mojang; and non-Microsoft products sold in our retail stores.

Our online application marketplaces are designed to benefit our developer and partner ecosystems by providing access to a large customer base and benefit users by providing centralized access to certified applications. Xbox Live transactions consist of online entertainment content, such as games, music, movies, and TV shows, accessible on Xbox consoles and other devices.

Search and display advertising includes Bing, Bing Ads, MSN, and Xbox ads. We have a partnership with Yahoo! in which we provide algorithmic and paid search platform for Yahoo! websites worldwide. In June 2015, we entered into agreements with AOL and AppNexus to outsource our display sales efforts.

Office 365 Consumer is designed to increase personal productivity through a range of Microsoft Office programs and services delivered across multiple platforms via the cloud.

Studios designs and markets games for Xbox consoles, Windows-enabled devices, and online. Growth depends on our ability to attract new users and increase engagement by developing a deep library of content that consumers seek.

We acquired Mojang Synergies AB (“Mojang”), the Swedish video game developer of the Minecraft gaming franchise, in November 2014. The addition of Minecraft and its community enhances our gaming portfolio across Windows, Xbox, and other ecosystems besides our own.

### Competition

We face competition for our Resale products and services from various online marketplaces, including those operated by Amazon, Apple, and Google.

Our search and display advertising business competes with Google and a wide array of websites, social platforms like Facebook, and portals like Yahoo! that provide content and online offerings to end users. Our success depends on our ability to attract new users, understand intent, and match intent with relevant content and advertiser offerings. We believe we can attract new users by continuing to offer new and compelling products and services.

Competitors to Office 365 Consumer are the same as those discussed above for Office Consumer.

Competitors to Studios and Mojang are the same as those discussed above for our Xbox gaming and entertainment business, as well as game studios like Electronic Arts and Activision Blizzard.

### **Commercial**

Our Commercial segments develop, market, and support software and services designed to increase individual, team, and organizational productivity and efficiency, including simplifying everyday tasks through seamless operations across the user’s hardware and software. Commercial is made up of the Commercial Licensing and Commercial Other segments.

#### *Commercial Licensing*

The principal products and services provided by the Commercial Licensing segment are: server products, including Windows Server, Microsoft SQL Server, Visual Studio, System Center, and related Client Access Licenses (“CALs”); Microsoft Office for business, including Office, Exchange, SharePoint, Skype for Business, and related CALs (“Office Commercial”); volume licensing of the Windows operating system, excluding academic (“Windows Commercial”); Microsoft Dynamics business solutions, excluding Dynamics CRM Online; Windows Embedded; and Skype.

Our server products are designed to make information technology professionals and developers and their systems more productive and efficient. Server software is integrated server infrastructure and middleware designed to support software applications built on the Windows Server operating system. This includes the server platform, database, business intelligence, storage, management and operations, virtualization, service-oriented architecture platform, security, and identity software. We also license standalone and software development lifecycle tools for software architects, developers, testers, and project managers. Revenue comes from purchases through volume licensing programs, licenses sold to OEMs, and retail packaged product. CALs provide access rights to certain server products, including Windows Server and SQL Server. CAL revenue is reported along with the associated server product.

The versions of Office in Commercial Licensing are designed to increase personal, team, and organizational productivity through a range of programs, services, and software solutions. Office Commercial revenue is mainly affected by a combination of the demand from commercial customers for volume licensing and software assurance and the number of information workers in a licensed enterprise. Office Commercial revenue growth depends on our ability to add value to the core product set and to continue to expand our product offerings in other areas such as content management, enterprise search, collaboration, unified communications, and business intelligence. CALs provide access rights to certain Office Commercial products, including Exchange, SharePoint, and Skype for Business, formerly Lync. CAL revenue is reported along with the associated Office product.

Windows Commercial includes volume licensing of the Windows operating system, excluding academic. Windows Commercial revenue is affected mainly by the demand from commercial customers for volume licensing and software assurance, often reflecting the number of information workers in a licensed enterprise, and is therefore relatively independent of the number of PCs sold in a given year.

Microsoft Dynamics products provide business solutions for financial management, customer relationship management, supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises. Revenue is largely driven by the number of information workers licensed.

Windows Embedded extends the power of Windows and the cloud to intelligent systems, including the Internet of Things (“IoT”), by delivering specialized operating systems, tools, and services.

Skype is designed to connect friends, family, clients, and colleagues through a variety of devices. Revenue is largely driven by the sale of minutes, subscriptions, and advertising.

### Competition

Our server products face competition from a wide variety of server operating systems and applications offered by companies with a range of market approaches. Vertically integrated computer manufacturers such as Hewlett-Packard, IBM, and Oracle offer their own versions of the Unix operating system preinstalled on server hardware. Nearly all computer manufacturers offer server hardware for the Linux operating system and many contribute to Linux operating system development. The competitive position of Linux has also benefited from the large number of compatible applications now produced by many commercial and non-commercial software developers. A number of companies, such as Red Hat, supply versions of Linux.

We compete to provide enterprise-wide computing solutions and point solutions with numerous commercial software vendors that offer solutions and middleware technology platforms, software applications for connectivity (both Internet and intranet), security, hosting, database, and e-business servers. IBM and Oracle lead a group of companies focused on the Java Platform Enterprise Edition that competes with our enterprise-wide computing solutions. Commercial competitors for our server applications for PC-based distributed client/server environments include CA Technologies, IBM, and Oracle. Our web application platform software competes with open source software such as Apache, Linux, MySQL, and PHP. In middleware, we compete against Java middleware vendors.

Our system management solutions compete with server management and server virtualization platform providers, such as BMC, CA Technologies, Hewlett-Packard, IBM, and VMware. Our database, business intelligence, and data warehousing solutions offerings compete with products from IBM, Oracle, SAP, and other companies. Our products for software developers compete against offerings from Adobe, IBM, Oracle, other companies, and open-source projects, including Eclipse (sponsored by CA Technologies, IBM, Oracle, and SAP), PHP, and Ruby on Rails, among others.

We believe our server products provide customers with advantages in performance, total costs of ownership, and productivity by delivering superior applications, development tools, compatibility with a broad base of hardware and software applications, security, and manageability.

Competitors to Office Commercial includes software application vendors such as Adobe Systems, Apple, Cisco Systems, Google, IBM, Oracle, SAP, and numerous web-based and mobile application competitors as well as local application developers in Asia and Europe. Cisco Systems is using its position in enterprise communications equipment to grow its unified communications business. Google provides a hosted messaging and productivity suite. Web-based offerings competing with individual applications have also positioned themselves as alternatives to our products. We believe our products compete effectively based on our strategy of providing powerful, flexible, secure, easy to use solutions that work well with technologies our customers already have and are available on a device or via the cloud.

Competitors to Windows Commercial are the same as those discussed above for Windows in the D&C Licensing segment.

Our Microsoft Dynamics products compete with vendors such as Oracle and SAP in the market for large organizations and divisions of global enterprises. In the market focused on providing solutions for small and mid-sized businesses, our Microsoft Dynamics products compete with vendors such as Infor, The Sage Group, and NetSuite. Salesforce.com’s cloud customer relationship management (“CRM”) offerings compete directly with Microsoft Dynamics CRM on-premises offerings.

Skype competes with a variety of instant messaging, voice, and video communication providers, ranging from start-ups to established enterprises.

### *Commercial Other*

The principal products and services provided by the Commercial Other segment are: Commercial Cloud, comprising Office 365 Commercial, Microsoft Azure, Dynamics CRM Online, and other Microsoft Office online offerings; and Enterprise Services, including Premier Support Services and Microsoft Consulting Services.

Office 365 Commercial is an online services offering that includes Microsoft Office, Exchange, SharePoint, and Skype for Business, and is available across a variety of devices and platforms.

Microsoft Azure is a scalable cloud platform with computing, networking, storage, database, and management, along with advanced services such as analytics, and comprehensive solutions such as Enterprise Mobility Suite. Microsoft Azure also includes a flexible platform that helps developers build, deploy, and manage enterprise, mobile, web, and IoT applications, for any platform or device without having to worry about the underlying infrastructure. Microsoft Azure enables customers to devote more resources to development and use of applications that benefit their organizations, rather than managing on-premises hardware and software.

Dynamics CRM Online is designed to provide customer relationship management and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises. Revenue is largely driven by the number of information workers licensed.

Enterprise Services, including Premier Support Services and Microsoft Consulting Services, assist customers in developing, deploying, and managing Microsoft server and desktop solutions and provide training and certification to developers and information technology professionals on various Microsoft products.

### Competition

Competitors to Office 365 Commercial are the same as those discussed above for Office Commercial.

Microsoft Azure faces diverse competition from companies such as Amazon, Google, IBM, Oracle, Salesforce.com, VMware, and open source offerings. Azure competes by enabling deployment of existing data centers with our public cloud into a single, cohesive infrastructure, and runs at a scale that meets the needs of businesses of all sizes and complexities.

Dynamics CRM Online primarily competes with Salesforce.com's on-demand CRM offerings.

The Enterprise Services business competes with a wide range of companies that provide strategy and business planning, application development, and infrastructure services, including multinational consulting firms and small niche businesses focused on specific technologies.

## OPERATIONS

We have operations centers that support all operations in their regions, including customer contract and order processing, credit and collections, information processing, and vendor management and logistics. The regional center in Ireland supports the European, Middle Eastern, and African region; the center in Singapore supports the Japan, India, Greater China, and Asia-Pacific region; and the centers in Fargo, North Dakota, Fort Lauderdale, Florida, Puerto Rico, Redmond, Washington, and Reno, Nevada support Latin America and North America. In addition to the operations centers, we also operate data centers throughout the Americas, Australia, Europe, and Asia.

To serve the needs of customers around the world and to improve the quality and usability of products in international markets, we localize many of our products to reflect local languages and conventions. Localizing a product may require modifying the user interface, altering dialog boxes, and translating text.

We operate manufacturing facilities for the production and customization of phones, predominantly in Vietnam.

Our Xbox consoles, Surface, first-party video games, Microsoft PC accessories, and other hardware are primarily manufactured by third-party contract manufacturers. We generally have the ability to use other manufacturers if a current vendor becomes unavailable or unable to meet our requirements.

## RESEARCH AND DEVELOPMENT

During fiscal years 2015, 2014, and 2013, research and development expense was \$12.0 billion, \$11.4 billion, and \$10.4 billion, respectively. These amounts represented 13% of revenue in each of those years. We plan to continue to make significant investments in a broad range of research and development efforts.

### **Product and Service Development and Intellectual Property**

We develop most of our products and services internally through three engineering groups.

- *Applications and Services Engineering Group*, focuses on broad applications and services core technologies in productivity, communication, education, search, and other information categories.
- *Cloud and Enterprise Engineering Group*, focuses on development of our cloud infrastructure, server, database, CRM, enterprise resource planning, management, development tools, and other business process applications and services for enterprises.
- *Windows and Devices Engineering Group*, focuses on our Windows platform across devices of all types, hardware development of our devices, including Xbox consoles, Surface devices, Lumia phones, non-Lumia phones, Surface Hub, Microsoft Band, and other hardware products and accessories, and associated online marketplaces.

Internal development allows us to maintain competitive advantages that come from product differentiation and closer technical control over our products and services. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. We strive to obtain information as early as possible about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing. Generally, we also create product documentation internally.

We protect our intellectual property investments in a variety of ways. We work actively in the U.S. and internationally to ensure the enforcement of copyright, trademark, trade secret, and other protections that apply to our software and hardware products, services, business plans, and branding. We are a leader among technology companies in pursuing patents and currently have a portfolio of over 57,000 U.S. and international patents issued and over 35,000 pending. While we employ much of our internally developed intellectual property exclusively in Microsoft products and services, we also engage in outbound and inbound licensing of specific patented technologies that are incorporated into licensees' or Microsoft's products. From time to time, we enter into broader cross-license agreements with other technology companies covering entire groups of patents. We also purchase or license technology that we incorporate into our products or services. At times, we make select intellectual property broadly available at no or low cost to achieve a strategic objective, such as promoting industry standards, advancing interoperability, or attracting and enabling our external development community.

While it may be necessary in the future to seek or renew licenses relating to various aspects of our products and business methods, we believe, based upon past experience and industry practice, such licenses generally could be obtained on commercially reasonable terms. We believe our continuing research and product development are not materially dependent on any single license or other agreement with a third party relating to the development of our products.

### **Investing in the Future**

Microsoft's success is based on our ability to create new and compelling products, services, and experiences for our users, to initiate and embrace disruptive technology trends, to enter new geographic and product markets, and to drive broad adoption of our products and services. We invest in a range of emerging technology trends and breakthroughs that we believe offer significant opportunities to deliver value to our customers and growth for the company. Based on our assessment of key technology trends and our broad focus on long-term research and development, we maintain our long-term commitment to research and development across a wide spectrum of technologies, tools, and platforms spanning digital work and life experiences, cloud computing, and devices operating systems and hardware.

While our main research and development facilities are located in Redmond, Washington, we also operate research and development facilities in other parts of the U.S. and around the world, including Canada, China, Denmark, Finland, France, Germany, India, Ireland, Israel, Japan, and the United Kingdom, among others. This global approach helps us remain competitive in local markets and enables us to continue to attract top talent from across the world. We generally fund research at the corporate level to ensure that we are looking beyond immediate product considerations to opportunities further in the future. We also fund research and development activities at the business segment level.

Much of our business segment level research and development is coordinated with other segments and leveraged across the company.

In addition to our main research and development operations, we also operate Microsoft Research. Microsoft Research is one of the world's largest computer science research organizations, and works in close collaboration with top universities around the world to advance the state-of-the-art in computer science, providing us a unique perspective on future technology trends and contributing to our innovation.

## DISTRIBUTION, SALES, AND MARKETING

We market and distribute our products and services through the following channels: OEMs; distributors and resellers; online; and Microsoft retail stores. Our sales force performs a variety of functions, including working directly with enterprises and public sector organizations worldwide to identify and meet their software requirements; managing OEM relationships; and supporting solution integrators, independent software vendors, and other partners who engage directly with our customers to perform sales, consulting, and fulfillment functions for our products.

### **OEMs**

We distribute software through OEMs that pre-install our software on new PCs, tablets, servers, phones, and other intelligent devices that they sell. The largest component of the OEM business is the Windows operating system pre-installed on computing devices. OEMs also sell hardware pre-installed with other Microsoft products, including server and embedded operating systems and applications such as our Microsoft Office suite. In addition to these products, we also market our services through OEMs and service bundles such as Windows with Bing or Windows with Office 365 subscription.

There are two broad categories of OEMs. The largest OEMs, many of which operate globally, are referred to as "Direct OEMs," as our relationship with them is managed through a direct agreement between Microsoft and the OEM. We have distribution agreements covering one or more of our products with virtually all of the multinational OEMs, including Acer, ASUSTeK, Dell, Fujitsu, Hewlett-Packard, Lenovo, Samsung, Toshiba, and with many regional and local OEMs. The second broad category of OEMs consists of lower-volume PC manufacturers (also called "system builders"), which source their Microsoft software for pre-installation and local redistribution primarily through the Microsoft distributor channel rather than through a direct agreement or relationship with Microsoft.

### **Distributors and Resellers**

Many organizations that license our products and services through enterprise agreements transact directly with us, with sales support from solution integrators, independent software vendors, web agencies, and developers that advise organizations on licensing our products and services ("Enterprise Agreement Direct Advisors", or "EDAs"). Organizations also license our products and services indirectly, primarily through license solutions partners ("LSPs"), distributors, value-added resellers ("VARs"), OEMs, system builder channels, and retailers. Although each type of reselling partner reaches organizations of all sizes, LSPs are primarily engaged with large organizations, distributors resell primarily to VARs, and VARs typically reach small-sized and medium-sized organizations. EDAs typically are also authorized as LSPs and operate as resellers for our other licensing programs, such as the Select Plus and Open licensing programs discussed under "Licensing Options" below. Some of our distributors include Ingram Micro and Tech Data, and some of our largest resellers include CDW, Dell, Insight Enterprises, and Software House International.

Our Microsoft Dynamics software offerings are also licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services. We distribute our retail packaged products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets. Individual consumers obtain these products primarily through retail outlets, including Microsoft retail stores. We distribute our hardware products, including Surface, Xbox, phones, and PC accessories, through third-party retailers and Microsoft retail stores. Our phones are also distributed through global wireless communications carriers. We have a network of field sales representatives and field support personnel that solicits orders from distributors and resellers, and provides product training and sales support.

### **Online**

Although on-premises software continues to be an important part of our business, increasingly we are delivering additional value to customers through cloud-based services. We provide online content services to consumers through Bing, MSN portals and channels, Office 365, Windows Phone Store, Xbox Live, Outlook.com, OneDrive, Skype, and Windows Store. We also provide commercial cloud-based services such as Dynamics CRM Online, Microsoft Azure, and Office 365. Other services delivered online include our online advertising platform with offerings for advertisers

and publishers, as well as Microsoft Developer Network subscription content and updates, periodic product updates, and online technical and practice readiness resources to support our partners in developing and selling our products and solutions. As we increasingly deliver online services, we sell many of these cloud-based services through our enterprise agreements and have also enabled new sales programs to reach small and medium-sized businesses. These programs include direct sales, direct sales supported by a large network of partner advisors, and resale of services through operator channels, such as telephone, cell, and cable providers.

We also sell our products through our Microsoft retail stores and online marketplaces.

## LICENSING OPTIONS

We license software to organizations under agreements that allow the customer to acquire multiple licenses of products and services. Our agreements for organizations to acquire multiple licenses of products and services are designed to provide them with a means of doing so without having to acquire separate licenses through retail channels. In delivering organizational licensing agreements to the market, we use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include those discussed below.

### **Customer Licensing Programs**

#### *Open Licensing*

Designed primarily for small-to-medium organizations, the Open Programs allow customers to acquire perpetual or subscription licenses and, at the customer's election, rights to future versions of software products over a specified time period (two or three years depending on the Open Programs used). The offering that conveys rights to future versions of certain software products over the contract period is called software assurance. Software assurance also provides support, tools, and training to help customers deploy and use software efficiently. The Open Programs have several variations to fit customers' diverse ways of purchasing. Under the Open License Program, customers can acquire licenses only or licenses with software assurance, and/or renew software assurance upon the expiration of other existing volume licensing agreements. Under the Open Value and Open Value Subscription programs, customers can acquire perpetual or subscription licenses, respectively, over a three-year period. Online services are available in each of the Open Programs.

#### *Microsoft Product and Services Agreement*

Suited for medium-to-large organizations, the Microsoft Products and Services Agreement ("MPSA") provides customers the ability to purchase online services subscriptions, software licenses, software licenses with software assurance, and renewals of software assurance through a single agreement. Software assurance and online services subscriptions are generally available up to three years.

#### *Select Plus Licensing*

Designed primarily for medium-to-large organizations, the Select Plus Program allows customers to acquire perpetual licenses and, at the customer's election, software assurance over a specified time period (generally three years or less). Similar to Open Programs, the Select Plus Program allows customers to acquire licenses only, acquire licenses with software assurance, or renew software assurance upon the expiration of existing volume licensing agreements. A subset of online services are also available for purchase through the Select Plus Program, and subscriptions are generally structured with terms between one and three years. In July 2014, we announced that we would no longer sign new Select Plus agreements with commercial organizations starting July 2015, and encouraged customers who want to purchase licenses to transition to the MPSA. We expect Select Plus business to transition to the MPSA within a few years.

#### *Enterprise Agreement Licensing*

Designed primarily for medium- and large-sized organizations that want to acquire licenses to online services and/or software products, along with software assurance and obtain the best value by standardizing on a common IT platform across the organization. Enterprises can elect to acquire perpetual licenses or, under the Enterprise Subscription option, can acquire non-perpetual, subscription licenses for a specified period (generally three years). Online services are also available for purchase through the enterprise agreement and subscriptions are generally structured with three-year terms.

## **Customer Licensing Programs — Online Services Only**

Microsoft Online Subscription Agreement is designed to enable small and medium-sized businesses to easily purchase Microsoft Online Services. The program allows customers to acquire monthly or annual subscriptions for cloud-based services.

## **Partner Programs**

The Microsoft Cloud Solution Provider program enables partners to directly manage their entire Microsoft cloud customer lifecycle. Partners in this program use dedicated in-product tools to directly provision, manage, and support their customer subscriptions. Partners can easily package their own tools, products, and services, and combine them into one monthly or annual customer bill.

The Microsoft Services Provider License Agreement is a program targeted at service providers and independent software vendors allowing these partners to provide software services and hosted applications to their end customers. Agreements are generally structured with a three-year term, and partners are billed monthly based upon consumption.

Microsoft Online Services Reseller Agreement is a program enabling partners to package Microsoft online services with the partners' services.

Independent Software Vendor Royalty Program is a program that enables partners to use Microsoft software in their own software programs.

## CUSTOMERS

Our customers include individual consumers, small- and medium-sized organizations, large global enterprises, public sector institutions, Internet service providers, application developers, and OEMs. No sales to an individual customer accounted for more than 10% of fiscal year 2015, 2014, or 2013 revenue. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

## EMPLOYEES

As of June 30, 2015, we employed approximately 118,000 people on a full-time basis, 60,000 in the U.S. and 58,000 internationally. Of the total employed people, 39,000 were in product research and development, 29,000 in sales and marketing, 32,000 in product support and consulting services, 8,000 in manufacturing and distribution, and 10,000 in general and administration. In June 2015, management approved a restructuring plan that will eliminate up to 7,800 positions in fiscal year 2016, primarily in our Phone Hardware business. As a result of the NDS acquisition, we have certain employees that are subject to collective bargaining agreements.

## AVAILABLE INFORMATION

Our Internet address is [www.microsoft.com](http://www.microsoft.com). At our Investor Relations website, [www.microsoft.com/investor](http://www.microsoft.com/investor), we make available free of charge a variety of information for investors. Our goal is to maintain the Investor Relations website as a portal through which investors can easily find or navigate to pertinent information about us, including:

- Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission ("SEC").
- Information on our business strategies, financial results, and key performance indicators.
- Announcements of investor conferences, speeches, and events at which our executives talk about our product, service, and competitive strategies. Archives of these events are also available.
- Press releases on quarterly earnings, product and service announcements, legal developments, and international news.
- Corporate governance information including our articles of incorporation, bylaws, governance guidelines, committee charters, codes of conduct and ethics, global corporate citizenship initiatives, and other governance-related policies.
- Other news and announcements that we may post from time to time that investors might find useful or interesting.
- Opportunities to sign up for email alerts and RSS feeds to have information pushed in real time.

The information found on our website is not part of this or any other report we file with, or furnish to, the SEC. In addition to these channels, we use social media to communicate to the public. It is possible that the information we post on social media could be deemed to be material to investors. We encourage investors, the media, and others interested in Microsoft to review the information we post on the social media channels listed on our Investor Relations website.

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

The following Management's Discussion and Analysis ("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 consolidated financial statements and the accompanying Notes to Financial Statements.

### OVERVIEW

Microsoft is a technology leader focused on building best-in-class platforms and productivity services for a mobile-first, cloud-first world. We strive to empower every person and every organization on the planet to achieve more. We develop and market software, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people's lives.

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

Much of our focus in fiscal year 2015 was toward transforming our organization to support our strategy of building best-in-class platforms and productivity services for a mobile-first, cloud-first world. We achieved product development milestones, implemented organizational changes, and made strategic and tactical moves to support the three central ambitions that support our strategy: reinventing productivity and business processes; building the intelligent cloud platform; and creating more personal computing.

Highlights from fiscal year 2015 included:

- Momentum continued to grow in our Commercial Cloud and productivity offerings as we surpassed an \$8 billion annualized run rate\* at the end of the year.
- Office 365 Commercial seats grew 74%, and Office 365 is now deployed in four out of five Fortune 500 enterprises, with more than half of that install base using premium workloads. We also added over 50,000 small- and medium-sized business customers each month.
- Server products and services revenue increased 9%, driven by growth across our cloud and on-premises server products. Azure revenue and compute usage increased by triple digits in the fourth quarter year over year, and we ended fiscal year 2015 with more than 17,000 Enterprise Mobility Services customers.
- We reached over 8 million paid Dynamics seats and refreshed and enhanced Microsoft Dynamics ERP products. We also introduced new social, productivity, mobility, customer service, and marketing capabilities in Dynamics CRM.
- We currently have more than 15 million Office 365 consumer subscribers, with new customers signing up at a current pace of nearly one million per month. We also surpassed 150 million downloads of Office mobile to iOS and Android devices.
- Bing exceeded 20% U.S. market share as we focused our advertising business on search. In June 2015, we entered into agreements with AOL and AppNexus to outsource our display sales efforts.
- In hardware, we released Surface 3 and expanded distribution of Surface Pro and the related gross margin percentage grew with increased revenue, and introduced new categories like HoloLens – all with an eye toward generating new growth in Windows more broadly.
- Xbox console volumes grew to over 12 million, and Xbox Live users increased 22%.

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\* Annualized run rate was calculated by multiplying June 2015 revenue by twelve months.

- We shipped over 36 million Lumia units, and announced the restructuring of our Phone Hardware business to run it more effectively near-term while driving reinvention longer term.

- We completed 16 acquisitions, including Mojang Synergies AB (“Mojang”), the Swedish video game developer of the Minecraft gaming franchise, and others, to strengthen our cloud platform and invest in mobile applications.
- We advanced Windows 10 to the threshold of its launch in July 2015 with the help of the Windows Insider Program, a new paradigm to incorporate unprecedented levels of user and developer feedback in our development process.

## **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, industry trends, and competitive forces.

## **Economic Conditions, Challenges, and Risks**

The market for software, devices, and cloud-based services is 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 devices and infrastructure will 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. Microsoft competes 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. Recently, the significant strengthening of the U.S. dollar relative to certain foreign currencies has negatively impacted reported revenue and reduced reported expenses from our international operations.

See a discussion of these factors and other risks under Risk Factors in our fiscal year 2015 Form 10-K.

## **Seasonality**

Our revenue historically has fluctuated quarterly and has generally been highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Computing and Gaming Hardware segment is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Computing and Gaming Hardware segment has generated approximately 40-50% of its yearly revenue in our second fiscal quarter.

## **Unearned Revenue**

Quarterly and annual revenue may be impacted by the deferral of revenue, including:

- Revenue deferred on pre-sales of Windows to original equipment manufacturers (“OEMs”) and retailers before general availability.
- Revenue deferred on bundled products and services (“Bundled Offerings”).
- Revenue deferred on sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price (the “Windows Upgrade Offer”).

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.

## Reportable Segments

The segment amounts included in MD&A are presented on a basis consistent with our internal management reporting. Segment information appearing in Note 22 – Segment Information and Geographic Data of the Notes to Financial Statements is also presented on this basis. All differences between our internal management reporting basis and accounting principles generally accepted in the United States (“U.S. GAAP”), along with certain corporate-level and other activity, are included in Corporate and Other. Operating expenses are not allocated to our segments. We have recast certain prior period amounts to conform to the current period presentation, with no impact on consolidated net income or cash flows.

On April 25, 2014, we acquired substantially all of Nokia Corporation’s (“Nokia”) Devices and Services business (“NDS”). NDS has been included in our consolidated results of operations since the acquisition date. We report the financial performance of the acquired business in our Phone Hardware segment. Prior to the acquisition of NDS, financial results associated with our joint strategic initiatives with Nokia were reflected in our Devices and Consumer (“D&C”) Licensing segment. The contractual relationship with Nokia related to those initiatives ended in conjunction with the acquisition.

Our reportable segments are described below.

### *Devices and Consumer*

Our D&C segments develop, manufacture, market, and support products and services designed to entertain and connect people, increase personal productivity, help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. Our D&C segments are:

- **D&C Licensing**, comprising: Windows, including all OEM licensing (“Windows OEM”) and other non-volume licensing and academic volume licensing of the Windows operating system and related software; non-volume licensing of Microsoft Office, comprising the core Office product set, for consumers (“Office Consumer”); Windows Phone operating system, including related patent licensing; and certain other patent licensing revenue.
- **Computing and Gaming Hardware**, comprising: Xbox gaming and entertainment consoles and accessories, second-party and third-party video game royalties, and Xbox Live subscriptions (“Xbox Platform”); Surface devices and accessories (“Surface”); and Microsoft PC accessories.
- **Phone Hardware**, comprising: Lumia phones and other non-Lumia phones, beginning with our acquisition of NDS.
- **D&C Other**, comprising: Resale, consisting of transactions in our Windows Store and Xbox marketplace; search advertising; display advertising; Office 365 Consumer, comprising Office 365 Home and Office 365 Personal; Studios, comprising first-party video games; Mojang; non-Microsoft products sold in our retail stores; and certain other consumer products and services not included in the categories above.

### *Commercial*

Our Commercial segments develop, market, and support software and services designed to increase individual, team, and organizational productivity and efficiency, including simplifying everyday tasks through seamless operations across the user’s hardware and software. Our Commercial segments are:

- **Commercial Licensing**, comprising: server products, including Windows Server, Microsoft SQL Server, Visual Studio, System Center, and related Client Access Licenses (“CALs”); Windows Embedded; volume licensing of the Windows operating system, excluding academic (“Windows Commercial”); Microsoft Office for business, including Office, Exchange, SharePoint, Skype for Business, and related CALs (“Office Commercial”); Microsoft Dynamics business solutions, excluding Dynamics CRM Online; and Skype.
- **Commercial Other**, comprising: Enterprise Services, including Premier Support Services and Microsoft Consulting Services; Commercial Cloud, comprising Office 365 Commercial, other Microsoft Office online offerings, Dynamics CRM Online, and Microsoft Azure; and certain other commercial products and online services not included in the categories above.

## SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
Revenue	\$ 93,580	\$ 86,833	\$ 77,849	8%	12%
Gross margin	\$ 60,542	\$ 59,755	\$ 57,464	1%	4%
Operating income	\$ 18,161	\$ 27,759	\$ 26,764	(35)%	4%
Diluted earnings per share	\$ 1.48	\$ 2.63	\$ 2.58	(44)%	2%

### *Fiscal year 2015 compared with fiscal year 2014*

Revenue increased \$6.7 billion or 8%, reflecting a full year of Phone Hardware sales and growth in revenue from our Commercial Cloud, Surface, server products, search advertising, and Xbox Live transactions. These increases were offset in part by a decline in revenue from Office Commercial, Windows OEM, licensing of Windows Phone operating system, and Office Consumer. Revenue included an unfavorable foreign currency impact of approximately 2%.

Gross margin increased \$787 million or 1%, primarily due to higher revenue, offset in part by a \$6.0 billion or 22% increase in cost of revenue. Cost of revenue increased, mainly due to Phone Hardware, as well as increasing costs in support of our Commercial Cloud, including \$396 million of higher datacenter expenses. Gross margin, as a percentage of revenue, improved year over year in each of our reportable segments.

Operating income decreased \$9.6 billion or 35%, primarily due to impairment, integration, and restructuring expenses in the current year, as well as increased research and development expenses, offset in part by higher gross margin. Key changes in operating expenses were:

- Impairment, integration, and restructuring expenses were \$10.0 billion in the current year, reflecting goodwill and asset impairment charges of \$7.5 billion related to our Phone Hardware business, and \$2.5 billion of integration and restructuring expenses, driven by costs associated with our restructuring plans.
- Research and development expenses increased \$665 million or 6%, mainly due to increased investment in new products and services, including NDS expenses, offset in part by reduced headcount-related expenses.

Diluted earnings per share ("EPS") were negatively impacted by impairment, integration, and restructuring expenses, which decreased diluted EPS by \$1.15.

### *Fiscal year 2014 compared with fiscal year 2013*

Revenue increased \$9.0 billion or 12%, demonstrating growth across our consumer and commercial businesses, primarily due to higher revenue from server products, Xbox Platform, Commercial Cloud, and Surface. Revenue also increased due to the acquisition of NDS. Commercial Cloud revenue doubled, reflecting continued subscriber growth from our cloud-based offerings.

Gross margin increased \$2.3 billion or 4%, primarily due to higher revenue, offset in part by a \$6.7 billion or 33% increase in cost of revenue. Cost of revenue increased mainly due to higher volumes of Xbox consoles and Surface devices sold, and \$575 million of higher datacenter expenses, primarily in support of Commercial Cloud revenue growth. Cost of revenue also increased due to the acquisition of NDS.

Operating income increased \$995 million or 4%, reflecting higher gross margin, offset in part by increased research and development expenses and sales and marketing expenses. Key changes in operating expenses were:

- Research and development expenses increased \$970 million or 9%, mainly due to increased investment in new products and services in our Devices engineering group, including NDS expenses, and increased investment in our Applications and Services engineering group.
- Sales and marketing expenses increased \$535 million or 4%, primarily due to NDS expenses and increased investment in sales resources, offset in part by lower advertising costs.

## SEGMENT RESULTS OF OPERATIONS

### Devices and Consumer

(In millions, except percentages)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
<b>Revenue</b>					
Licensing	<b>\$ 14,969</b>	\$ 19,528	\$ 19,427	(23)%	1%
Hardware:					
Computing and Gaming Hardware	<b>10,183</b>	9,093	6,149	12%	48%
Phone Hardware	<b>7,524</b>	1,982	0	*	*
<hr/>					
Total Devices and Consumer Hardware	<b>17,707</b>	11,075	6,149	60%	80%
Other	<b>8,825</b>	7,014	6,431	26%	9%
<hr/>					
Total Devices and Consumer revenue	<b>\$ 41,501</b>	\$ 37,617	\$ 32,007	10%	18%
<b>Gross Margin</b>					
Licensing	<b>\$ 13,870</b>	\$ 17,439	\$ 16,985	(20)%	3%
Hardware:					
Computing and Gaming Hardware	<b>1,788</b>	892	956	100%	(7)%
Phone Hardware	<b>701</b>	54	0	*	*
<hr/>					
Total Devices and Consumer Hardware	<b>2,489</b>	946	956	163%	(1)%
Other	<b>2,022</b>	1,393	1,951	45%	(29)%
<hr/>					
Total Devices and Consumer gross margin	<b>\$ 18,381</b>	\$ 19,778	\$ 19,892	(7)%	(1)%

\* *Not meaningful*

#### *Fiscal year 2015 compared with fiscal year 2014*

D&C revenue increased \$3.9 billion or 10%, primarily due to a full year of Phone Hardware sales, as well as higher revenue from Surface, search advertising, and Xbox Live transactions, offset in part by a decrease in revenue from Windows OEM, licensing of Windows Phone operating system, and Office Consumer. Collectively, Office Consumer and Office 365 Consumer revenue declined 17%. D&C gross margin decreased \$1.4 billion or 7%, reflecting higher cost of revenue, offset in part by higher revenue. D&C cost of revenue increased \$5.3 billion or 30%, mainly due to a full year of Phone Hardware costs.

#### D&C Licensing

D&C Licensing revenue decreased \$4.6 billion or 23%, mainly due to lower revenue from Windows OEM, Windows Phone licensing, and Office Consumer. Windows OEM revenue declined \$1.9 billion or 15%, primarily due to declines of 15% in OEM Pro revenue and 16% in OEM non-Pro revenue. Windows OEM Pro revenue decreased, primarily due to benefits realized from the expiration of support for Windows XP in the prior year, and declines in the business PC market. Windows OEM non-Pro revenue declined, mainly due to an increased mix of opening price point devices sold, and declines in the consumer PC market. Revenue from licensing of Windows Phone operating system decreased \$1.4 billion or 55%, primarily due to prior year revenue associated with our joint strategic initiatives with Nokia that terminated when we acquired NDS. Office Consumer revenue declined \$946 million or 29%, reflecting the transition of customers to Office 365 Consumer, where revenue is recognized ratably, and declines in the Japan PC market, where Office is predominantly pre-installed on new PCs.

D&C Licensing gross margin decreased \$3.6 billion or 20%, primarily due to the decline in revenue, offset in part by a \$990 million or 47% decrease in cost of revenue. D&C Licensing cost of revenue decreased, mainly due to a \$788 million decline in traffic acquisition costs, driven by prior year costs associated with our joint strategic initiatives with Nokia that terminated when we acquired NDS.

## Computing and Gaming Hardware

Computing and Gaming Hardware revenue increased \$1.1 billion or 12%, primarily due to higher revenue from Surface, offset in part by lower revenue from Xbox Platform. Surface revenue increased 65% to \$3.6 billion, primarily due to Surface Pro 3 units sold. Surface Pro 3 was released in June 2014. Xbox Platform revenue decreased \$385 million or 6%, driven by lower prices of Xbox One consoles compared to the prior year, as well as a decrease in second- and third-party video games revenue. We sold 12.1 million Xbox consoles in fiscal year 2015 compared with 11.7 million consoles in fiscal year 2014.

Computing and Gaming Hardware gross margin increased \$896 million or 100%, mainly due to higher revenue, offset in part by a \$194 million or 2% increase in cost of revenue. Gross margin expansion was driven by Surface, which benefited from the mix shift to Surface Pro 3. Xbox Platform cost of revenue was comparable to the prior year.

## Phone Hardware

Phone Hardware revenue increased \$5.5 billion, as we sold 36.8 million Lumia phones and 126.8 million other non-Lumia phones in fiscal year 2015, compared with 5.8 million and 30.3 million sold, respectively, in fiscal year 2014 following the acquisition of NDS. We acquired NDS in the fourth quarter of fiscal year 2014.

Phone Hardware gross margin increased \$647 million, primarily due to higher revenue, offset in part by higher cost of revenue. Phone Hardware cost of revenue increased \$4.9 billion, and included \$476 million of amortization of acquired intangible assets in fiscal year 2015.

We recorded goodwill and asset impairment charges of \$7.5 billion related to our Phone Hardware business in the fourth quarter of fiscal year 2015. See further discussion under Impairment, Integration, and Restructuring Expenses below.

## D&C Other

D&C Other revenue increased \$1.8 billion or 26%, mainly due to higher revenue from search advertising, Xbox Live, first-party video games, including Minecraft, and Office 365 Consumer. D&C Other revenue included an unfavorable foreign currency impact of approximately 2%. Search advertising revenue increased \$651 million or 22%, primarily driven by growth in Bing, due to higher revenue per search and search volume. Xbox Live and other store transaction revenue increased \$531 million, driven by increased Xbox Live users and revenue per user. First-party video games revenue increased \$367 million, mainly due to sales of Minecraft following the acquisition of Mojang in November 2014, and new Xbox titles released in the current year. Office 365 Consumer revenue increased \$323 million, reflecting subscriber growth.

D&C Other gross margin increased \$629 million or 45%, due to higher revenue, offset in part by a \$1.2 billion or 21% increase in cost of revenue. D&C Other cost of revenue grew, mainly due to \$372 million higher Xbox Live and other store transaction costs, a \$279 million increase in search infrastructure costs, \$267 million higher retail stores expenses, and \$194 million higher first-party video games and Minecraft costs.

## *Fiscal year 2014 compared with fiscal year 2013*

D&C revenue increased \$5.6 billion or 18%, primarily due to higher revenue from Xbox Platform, Surface, and Windows Phone. Revenue also increased \$2.0 billion due to the acquisition of NDS. D&C gross margin decreased slightly, reflecting higher cost of revenue, offset in part by higher revenue. Cost of revenue increased \$5.7 billion or 47%, mainly due to Xbox Platform and Surface. Cost of revenue also increased \$1.9 billion due to NDS.

## D&C Licensing

D&C Licensing revenue increased \$101 million or 1%, mainly due to increased Windows Phone revenue, offset in part by lower revenue from licenses of Windows and Office Consumer. Windows Phone revenue increased \$822 million or 48%, mainly due to the recognition of \$382 million revenue under our joint strategic initiatives with Nokia, which concluded in conjunction with the acquisition of NDS, as well as an increase in phone patent licensing revenue. Retail and non-OEM sales of Windows declined \$274 million or 35%, mainly due to the launch of Windows 8 in the prior year. Windows OEM revenue declined \$136 million or 1%, due to continued softness in the consumer PC market, offset in part by a 12% increase in OEM Pro revenue. Office Consumer revenue declined \$249 million or 7%, reflecting the transition of customers to Office 365 Consumer as well as continued softness in the consumer PC market. The declines in Windows OEM and Office Consumer revenue were partially offset by benefits realized from ending our support for Windows XP in April 2014.

D&C Licensing gross margin increased \$454 million or 3%, primarily due to a \$353 million or 14% decrease in cost of revenue. D&C Licensing cost of revenue decreased, mainly due to a \$411 million or 23% decline in traffic acquisition costs.

### Computing and Gaming Hardware

Computing and Gaming Hardware revenue increased \$2.9 billion or 48%, primarily due to higher revenue from the Xbox Platform and Surface. Xbox Platform revenue increased \$1.7 billion or 34%, mainly due to sales of Xbox One, which was released in November 2013, offset in part by a decrease in sales of Xbox 360. We sold 11.7 million Xbox consoles during fiscal year 2014 compared with 9.8 million Xbox consoles during fiscal year 2013. Surface revenue increased \$1.3 billion or 157%, mainly due to a higher number of devices and accessories sold.

Computing and Gaming Hardware gross margin decreased slightly, due to a \$3.0 billion or 58% increase in cost of revenue, offset in part by higher revenue. Xbox Platform cost of revenue increased \$2.1 billion or 72%, mainly due to higher volumes of consoles sold and higher costs associated with Xbox One. Surface cost of revenue increased \$970 million or 51%, mainly due to a higher number of devices and accessories sold, offset in part by a charge for Surface RT inventory adjustments of approximately \$900 million in fiscal year 2013.

### Phone Hardware

Phone Hardware revenue was \$2.0 billion in fiscal year 2014, reflecting sales of Lumia phones and other non-Lumia phones following the acquisition of NDS on April 25, 2014. Since the acquisition, we sold 5.8 million Lumia phones and 30.3 million other non-Lumia phones in fiscal year 2014.

Phone Hardware gross margin was \$54 million in fiscal year 2014, reflecting revenue of \$2.0 billion, offset in part by \$1.9 billion cost of revenue, including amortization of acquired intangible assets and the impact of decisions to rationalize our device portfolio.

### D&C Other

D&C Other revenue increased \$583 million or 9%, mainly due to higher online advertising revenue and Office 365 Consumer revenue, offset in part by a \$213 million decrease in first-party video games revenue, primarily due to the release of Halo 4 in the second quarter of fiscal year 2013. Online advertising revenue increased \$497 million or 14%. Search advertising revenue increased 39%, primarily due to increased revenue per search resulting from ongoing improvements in advertising products, higher search volume, and the expiration of North American revenue per search guarantee payments to Yahoo! in the prior year, offset in part by a 25% reduction in display advertising revenue. Office 365 Consumer revenue grew \$316 million, primarily reflecting subscriber growth. We ended fiscal year 2014 with over five million subscribers.

D&C Other gross margin decreased \$558 million or 29%, due to a \$1.1 billion or 25% increase in cost of revenue, offset in part by higher revenue. D&C Other cost of revenue grew, mainly due to a \$541 million or 24% increase in online advertising cost of revenue, reflecting support of online infrastructure. Cost of revenue also increased \$219 million or 15%, due to higher resale transactions costs.

### **Commercial**

(In millions, except percentages)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
<b>Revenue</b>					
Licensing	\$ 41,039	\$ 42,085	\$ 39,778	(2)%	6%
Other	10,836	7,546	5,661	44%	33%
Total Commercial revenue	\$ 51,875	\$ 49,631	\$ 45,439	5%	9%
<b>Gross Margin</b>					
Licensing	\$ 37,830	\$ 38,615	\$ 36,280	(2)%	6%
Other	4,199	1,855	922	126%	101%
Total Commercial gross margin	\$ 42,029	\$ 40,470	\$ 37,202	4%	9%

#### *Fiscal year 2015 compared with fiscal year 2014*

Commercial revenue increased \$2.2 billion or 5%, mainly due to growth in revenue from our Commercial Cloud and server products, offset in part by a decline in Office Commercial. Commercial revenue included an unfavorable foreign currency impact of approximately 2%. Our server products and services grew 9%. Our Office Commercial products and services declined 1%. Commercial gross margin increased \$1.6 billion or 4%.

#### Commercial Licensing

Commercial Licensing revenue decreased \$1.0 billion or 2%, primarily due to a decline in revenue from Office Commercial, offset in part by increased revenue from our server products. Commercial Licensing revenue included an unfavorable foreign currency impact of approximately 2%. Office Commercial revenue declined \$2.5 billion or 13%, due to lower transactional license volume, reflecting a decline in the business PC market following Windows XP end of support in the prior year, customers transitioning to Office 365 Commercial, and declines in Japan. Our server products revenue grew \$1.1 billion or 7%, primarily driven by higher premium mix of Microsoft SQL Server, Windows Server, and System Center.

Commercial Licensing gross margin decreased \$785 million or 2%, in line with revenue.

#### Commercial Other

Commercial Other revenue increased \$3.3 billion or 44%, primarily due to higher Commercial Cloud revenue. Commercial Other revenue included an unfavorable foreign currency impact of approximately 3%. Commercial Cloud revenue grew \$3.0 billion or 106%, mainly due to subscriber growth and higher premium mix of Office 365 Commercial, as well as continued revenue growth from Microsoft Azure.

Commercial Other gross margin increased \$2.3 billion or 126%, due to higher revenue, offset in part by a \$946 million or 17% increase in cost of revenue. The increase in Commercial Other cost of revenue was mainly due to higher datacenter and other online infrastructure expenses, reflecting increased datacenter capacity to serve our growing Commercial Cloud.

#### *Fiscal year 2014 compared with fiscal year 2013*

Commercial revenue increased \$4.2 billion or 9%, mainly due to growth in revenue from our on-premises licensing businesses and Commercial Cloud. Collectively, Office Commercial and Office 365 Commercial revenue grew 7%. Collectively, our server products revenue, including Microsoft Azure, grew 13%. Commercial gross margin increased \$3.3 billion or 9%, in line with revenue.

#### Commercial Licensing

Commercial Licensing revenue increased \$2.3 billion or 6%, primarily due to increased revenue from our server products, as well as higher revenue from Windows Commercial and Office Commercial. Our server products revenue grew \$1.7 billion or 11%, driven primarily by increased sales of Microsoft SQL Server. Windows Commercial revenue grew \$334 million or 10%, mainly due to increased renewal rates and transactional purchases driven by Windows XP end of support. Office Commercial revenue grew \$219 million or 1%, and was impacted by customers transitioning to Office 365 Commercial.

Commercial Licensing gross margin increased \$2.3 billion or 6%, in line with revenue growth.

#### Commercial Other

Commercial Other revenue increased \$1.9 billion or 33%, due to higher Commercial Cloud revenue and Enterprise Services revenue. Commercial Cloud revenue grew \$1.5 billion or 116%, mainly due to higher revenue from Office 365 Commercial. Enterprise Services revenue grew \$380 million or 9%, mainly due to growth in Premier Support Services.

Commercial Other gross margin increased \$933 million or 101%, due to higher revenue, offset in part by a \$952 million or 20% increase in cost of revenue. The increase in cost of revenue was mainly due to higher datacenter expenses, reflecting support of our growing Commercial Cloud.

## Corporate and Other

(In millions, except percentages)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
Revenue	\$ 204	\$ (415)	\$ 403	149%	(203)%
Gross margin	\$ 132	\$ (493)	\$ 370	127%	(233)%

Corporate and Other revenue comprises certain revenue deferrals, including those related to product and service upgrade offers and pre-sales of new products to OEMs prior to general availability.

### *Fiscal year 2015 compared with fiscal year 2014*

Corporate and Other revenue increased \$619 million, primarily due to the timing of revenue deferrals compared to the prior year. During fiscal year 2015, we recognized a net \$303 million of previously deferred revenue related to Bundled Offerings. During fiscal year 2014, we deferred a net \$349 million of revenue related to Bundled Offerings.

Corporate and Other gross margin increased \$625 million, primarily due to increased revenue.

### *Fiscal year 2014 compared with fiscal year 2013*

Corporate and Other revenue decreased \$818 million, primarily due to the timing of revenue deferrals. During fiscal year 2014, we deferred a net \$349 million of revenue related to Bundled Offerings. During fiscal year 2013, we recognized \$540 million of previously deferred revenue related to the Windows Upgrade Offer. The revenue was recognized upon expiration of the offer.

Corporate and Other gross margin decreased \$863 million, mainly due to decreased revenue.

## OPERATING EXPENSES

### Research and Development

(In millions, except percentages)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
Research and development	\$ 12,046	\$ 11,381	\$ 10,411	6%	9%
As a percent of revenue	13%	13%	13%	Oppt	Oppt

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.

### *Fiscal year 2015 compared with fiscal year 2014*

Research and development expenses increased \$665 million or 6%, mainly due to increased investment in new products and services, including \$739 million higher NDS expenses, offset in part by reduced headcount-related expenses.

### *Fiscal year 2014 compared with fiscal year 2013*

Research and development expenses increased \$970 million or 9%, mainly due to increased investment in new products and services in our Devices engineering group, including \$275 million of NDS expenses, and increased investment in our Applications and Services engineering group.

## Sales and Marketing

(In millions, except percentages)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
Sales and marketing	\$ 15,713	\$ 15,811	\$ 15,276	(1)%	4%
As a percent of revenue	17%	18%	20%	(1)ppt	(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.

### *Fiscal year 2015 compared with fiscal year 2014*

Sales and marketing expenses decreased \$98 million or 1%, primarily due to a decline in advertising and marketing programs costs and a reduction in headcount-related expenses, offset in part by an increase in NDS expenses. Sales and marketing expenses included a favorable foreign currency impact of approximately 4%.

### *Fiscal year 2014 compared with fiscal year 2013*

Sales and marketing expenses increased \$535 million or 4%, primarily due to NDS expenses and increased investment in sales resources, offset in part by lower advertising costs. NDS sales and marketing expenses were \$394 million during fiscal year 2014. Average headcount, excluding NDS, grew 4%. Advertising costs, excluding NDS, declined \$403 million or 15%, primarily due to Windows 8 and Surface costs in the prior year.

## General and Administrative

(In millions, except percentages)	2015	2014	2013	Percentage Change 2015 Versus 2014	Percentage Change 2014 Versus 2013
General and administrative	\$ 4,611	\$ 4,677	\$ 5,013	(1)%	(7)%
As a percent of revenue	5%	5%	6%	0ppt	(1)ppt

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.

### *Fiscal year 2015 compared with fiscal year 2014*

General and administrative expenses were comparable to the prior year.

### *Fiscal year 2014 compared with fiscal year 2013*

General and administrative expenses decreased \$336 million or 7%, mainly due to the European Commission fine in the prior year, offset in part by higher business taxes, higher costs for internal use software capitalized in the prior year, and NDS expenses. NDS general and administrative expenses were \$77 million during fiscal year 2014.

## IMPAIRMENT, INTEGRATION, AND RESTRUCTURING EXPENSES

Impairment, integration, and restructuring expenses include costs associated with the impairment of goodwill and intangible assets related to our Phone Hardware business, employee severance expenses and costs associated with the consolidation of facilities and manufacturing operations related to restructuring activities, and systems consolidation and other business integration expenses associated with our acquisition of NDS.

### *Fiscal year 2015 compared with fiscal year 2014*

Impairment, integration, and restructuring expenses were \$10.0 billion for fiscal year 2015, compared to \$127 million for fiscal year 2014. The increase was mainly due to impairment charges of \$7.5 billion related to our Phone Hardware business in the fourth quarter of fiscal year 2015. Our annual goodwill impairment test as of May 1, 2015 indicated that the carrying value of Phone Hardware goodwill exceeded its estimated fair value. Accordingly, we recorded a goodwill

impairment charge of \$5.1 billion, reducing Phone Hardware's goodwill from \$5.4 billion to \$116 million, net of foreign currency remeasurements, as well as an impairment charge of \$2.2 billion related to the write-down of Phone Hardware intangible assets. Restructuring charges were \$2.1 billion, including employee severance expenses and the write-down of certain assets in connection with our restructuring activities. Integration expenses increased \$308 million, due to a full-year of integration activities in fiscal year 2015 associated with the acquisition of NDS.

*Fiscal year 2014 compared with fiscal year 2013*

Impairment, integration, and restructuring expenses were \$127 million for fiscal year 2014, reflecting integration expenses associated with the acquisition of NDS. No impairment, integration, and restructuring expenses were recorded in fiscal year 2013.

OTHER INCOME (EXPENSE), NET

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

(In millions)

Year Ended June 30,	2015	2014	2013
Dividends and interest income	\$ 766	\$ 883	\$ 677
Interest expense	(781)	(597)	(429)
Net recognized gains on investments	716	437	116
Net losses on derivatives	(423)	(328)	(196)
Net gains (losses) on foreign currency remeasurements	335	(165)	(74)
Other	(267)	(169)	194
Total	\$ 346	\$ 61	\$ 288

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

*Fiscal year 2015 compared with fiscal year 2014*

Dividends and interest income decreased due to lower yields on fixed income securities, offset in part by higher portfolio balances. Interest expense increased due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities, offset in part by higher other-than-temporary impairments. Other-than-temporary impairments were \$183 million in fiscal year 2015, compared with \$106 million in fiscal year 2014. Net losses on derivatives increased due to losses on commodity contracts in the current period as compared to gains in the prior period, offset in part by lower losses on currency and equity contracts. For fiscal year 2015, other reflects recognized losses from certain joint ventures and divestitures.

*Fiscal year 2014 compared with fiscal year 2013*

Dividends and interest income increased due to higher portfolio balances. Interest expense increased due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities and lower other-than-temporary impairments. Other-than-temporary impairments were \$106 million in fiscal year 2014, compared with \$208 million in fiscal year 2013. Net losses on derivatives increased due to higher losses on foreign exchange contracts, losses on equity derivatives as compared to gains in the prior period, offset in part by gains on commodity and interest rate derivatives as compared to losses in the prior period. For fiscal year 2014, other reflects recognized losses from certain joint ventures, offset in part by a recognized gain on a divestiture. For fiscal year 2013, other reflects recognized gains on divestitures, including the gain recognized upon the divestiture of our 50% share in the MSNBC joint venture.

## INCOME TAXES

### *Fiscal year 2015 compared with fiscal year 2014*

Our effective tax rate for fiscal years 2015 and 2014 was approximately 34% and 21%, respectively. The fiscal year 2015 effective rate increased by 13%, primarily due to goodwill and asset impairments and restructuring charges recorded in fiscal year 2015, most of which did not generate a tax benefit. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to foreign earnings taxed at lower rates resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico. In fiscal year 2015, this reduction was mostly offset by losses in foreign jurisdictions for which we may not realize a tax benefit, primarily as a result of impairment and restructuring charges.

Changes in the mix of income before income taxes between the U.S. and foreign countries also impacted our effective tax rates and resulted primarily from changes in the geographic distribution of and changes in consumer demand for our products and services. We supply our Windows PC operating system to customers through our U.S. regional operating center, while we supply the Microsoft Office system and our server products and tools to customers through our foreign regional operations centers. In fiscal years 2015 and 2014, our U.S. income before income taxes was \$7.4 billion and \$7.1 billion, respectively, and comprised 40% and 26%, respectively, of our income before income taxes. In fiscal years 2015 and 2014, our foreign income before income taxes was \$11.1 billion and \$20.7 billion, respectively, and comprised 60% and 74%, respectively, of our income before income taxes.

Tax contingencies and other income tax liabilities were \$12.1 billion and \$10.4 billion as of June 30, 2015 and 2014, respectively, and are included in other long-term liabilities. This increase relates primarily to adjustments to prior years' liabilities for intercompany transfer pricing and adjustments related to our IRS audits. While we settled a portion of the I.R.S. audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, we remain under audit for those years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of June 30, 2015, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2015.

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 2015, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

### *Fiscal year 2014 compared with fiscal year 2013*

Our effective tax rate for fiscal years 2014 and 2013 was approximately 21% and 19%, respectively. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

Our fiscal year 2014 effective rate increased by 2% from fiscal year 2013 mainly due to adjustments of \$458 million to prior years' liabilities for intercompany transfer pricing that increased taxable income in more highly taxed jurisdictions, as well as losses incurred by NDS and changes in the geographic mix of our business. This was offset in part by favorable transfer pricing developments in certain foreign tax jurisdictions, primarily Denmark.

Changes in the mix of income before income taxes between the U.S. and foreign countries also impacted our effective tax rates and resulted primarily from changes in the geographic distribution of and changes in consumer demand for our products and services. We supply our Windows PC operating system to customers through our U.S. regional operating center, while we supply the Microsoft Office system and our server products and tools to customers through our foreign regional operations centers. Windows PC operating system revenue decreased \$655 million in fiscal year 2014, while Microsoft Office system and server products and tools revenue increased \$1.3 billion and \$1.6 billion, respectively, during this same period. In fiscal years 2014 and 2013, our U.S. income before income taxes was \$7.1 billion and \$6.7 billion, respectively, and comprised 26% and 25%, respectively, of our income before income taxes. In fiscal years 2014 and 2013, the foreign income before income taxes was \$20.7 billion and \$20.4 billion, respectively, and comprised 74% and 75%, respectively, of our income before income taxes.

## FINANCIAL CONDITION

### **Cash, Cash Equivalents, and Investments**

Cash, cash equivalents, and short-term investments totaled \$96.5 billion as of June 30, 2015, compared with \$85.7 billion as of June 30, 2014. Equity and other investments were \$12.1 billion as of June 30, 2015, compared with \$14.6 billion as of June 30, 2014. Our short-term investments are primarily to facilitate liquidity and for 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 in order 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.

Of the cash, cash equivalents, and short-term investments at June 30, 2015, \$94.4 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash, cash equivalents, and short-term investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was \$2.1 billion. As of June 30, 2015, approximately 79% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 5% were invested in corporate notes and bonds of U.S. companies, and approximately 5% were invested in U.S. mortgage- and asset-backed securities, all of which are denominated in U.S. dollars.

#### *Securities lending*

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was \$92 million as of June 30, 2015. Our average and maximum securities lending payable balances for the fiscal year were \$287 million and \$750 million, respectively. Intra-year variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

#### *Valuation*

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

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

### **Cash Flows**

#### *Fiscal year 2015 compared with fiscal year 2014*

Cash flows from operations decreased \$3.2 billion during the fiscal year to \$29.1 billion, mainly due to an increase in materials and production costs in support of sales growth as well as payments related to restructuring charges and

other changes in working capital, offset in part by increases in cash received from customers. Cash used in financing increased \$686 million to \$9.1 billion, mainly due to a \$7.1 billion increase in cash used for common stock repurchases, offset in part by a \$6.7 billion increase in proceeds from issuances of debt, net of repayments. Cash used in investing increased \$4.2 billion to \$23.0 billion, mainly due to a \$5.5 billion increase in cash used for net investment purchases, sales, and maturities, partially offset by a \$2.2 billion decrease in cash used for acquisitions of companies and purchases of intangible and other assets.

*Fiscal year 2014 compared with fiscal year 2013*

Cash flows from operations increased \$3.4 billion during fiscal year 2014 to \$32.2 billion, mainly due to increases in cash received from customers. Cash used in financing increased \$246 million to \$8.4 billion, mainly due to a \$2.0 billion increase in cash used for common stock repurchases, a \$1.4 billion increase in dividends paid, and a \$324 million decrease in proceeds from the issuance of common stock, offset in part by a \$3.4 billion increase in proceeds from issuances of debt, net of repayments. Cash used in investing decreased \$5.0 billion to \$18.8 billion, mainly due to a \$10.5 billion decrease in cash used for net investment purchases, sales, and maturities, offset in part by a \$4.4 billion increase in cash used for acquisition of companies and purchases of intangible and other assets, and a \$1.2 billion increase in capital expenditures for property and equipment.

**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. See Note 12 – Debt of the Notes to Financial Statements for further discussion.

**Unearned Revenue**

Unearned revenue at June 30, 2015 was comprised mainly of unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each coverage period and accounted for as subscriptions with revenue recognized ratably over the coverage period. Unearned revenue at June 30, 2015 also included payments for: post-delivery support and consulting services to be performed in the future; Xbox Live subscriptions and prepaid points; Microsoft Dynamics business solutions products; Office 365 subscriptions; Skype prepaid credits and subscriptions; Bundled Offerings; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of June 30, 2015:

(In millions)

Three Months Ending,	
September 30, 2015	\$ 8,889
December 31, 2015	7,172
March 31, 2016	4,848
June 30, 2016	2,314
Thereafter	2,095
Total	<u>\$ 25,318</u>

**Share Repurchases**

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to \$40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. While the program has no expiration date, we intend to complete it by December 31, 2016. As of June 30, 2015, \$21.9 billion remained of our \$40.0 billion share repurchase program.

During fiscal year 2015, we repurchased 295 million shares of Microsoft common stock for \$13.2 billion under the share repurchase program approved by our Board of Directors on September 16, 2013. During fiscal year 2014, we repurchased 175 million shares for \$6.4 billion; 128 million shares were repurchased for \$4.9 billion under the share

repurchase program approved by our Board of Directors on September 16, 2013, and 47 million shares were repurchased for \$1.5 billion under the share repurchase program that was announced on September 22, 2008 and expired September 30, 2013. During fiscal year 2013, we repurchased 158 million shares for \$4.6 billion, under the share repurchase program announced on September 22, 2008. All repurchases were made using cash resources.

## Dividends

See Note 19 – Stockholders’ Equity of the Notes to Financial Statements for further discussion.

## Off-Balance Sheet Arrangements

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

## Contractual Obligations

The following table summarizes the payments due by fiscal year for our outstanding contractual obligations as of June 30, 2015:

(In millions)	2016	2017-2018	2019-2020	Thereafter	Total
Long-term debt: <sup>(a)</sup>					
Principal payments	\$ 2,500	\$ 1,050	\$ 3,750	\$ 23,163	\$ 30,463
Interest payments	855	1,641	1,552	11,412	15,460
Construction commitments <sup>(b)</sup>	681	0	0	0	681
Operating leases <sup>(c)</sup>	863	1,538	1,135	1,617	5,153
Purchase commitments <sup>(d)</sup>	13,018	989	164	261	14,432
Other long-term liabilities <sup>(e)</sup>	0	237	75	639	951
Total contractual obligations	<u>\$ 17,917</u>	<u>\$ 5,455</u>	<u>\$ 6,676</u>	<u>\$ 37,092</u>	<u>\$ 67,140</u>

(a) See Note 12 – Debt of the Notes to Financial Statements.

(b) These amounts represent commitments for the construction of buildings, building improvements, and leasehold improvements.

(c) These amounts represent undiscounted future minimum rental commitments under noncancellable facilities leases.

(d) These amounts represent purchase commitments, including all open purchase orders and all contracts that are take-or-pay contracts that are not presented as construction commitments above.

(e) We have excluded long-term tax contingencies, other tax liabilities, deferred income taxes, and long-term pension liabilities of \$15.2 billion from the amounts presented. We have also excluded unearned revenue and non-cash items.

## 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, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We expect capital expenditures to increase in coming years in support of our productivity and platform strategy. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

## Liquidity

We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. As a result, as discussed above under Cash, Cash Equivalents, and Investments, the majority of our cash, cash equivalents, and short-term investments are held by foreign subsidiaries. We currently do not intend

nor foresee a need to repatriate these funds. We expect existing domestic cash, cash equivalents, short-term investments, cash flows from operations, and access to capital markets to continue to be sufficient to fund our domestic operating activities and cash commitments for investing and financing activities, such as regular quarterly dividends, debt maturities, and material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future. In addition, we expect existing foreign cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our foreign operating activities and cash commitments for investing activities, such as material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future.

Should we require more capital in the U.S. than is generated by our operations domestically, for example to fund significant discretionary activities, such as business acquisitions and share repurchases, we could elect to repatriate future earnings from foreign jurisdictions or raise capital in the U.S. through debt or equity issuances. These alternatives could result in higher effective tax rates, increased interest expense, or dilution of our earnings. We have borrowed funds domestically and continue to believe we have the ability to do so at reasonable interest rates.

### RECENT ACCOUNTING GUIDANCE

See Note 1 – Accounting Policies of the Notes to Financial Statements for further discussion.

### APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements and accompanying notes are prepared in accordance with U.S. 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**

Revenue recognition for multiple-element arrangements requires judgment to determine if multiple elements exist, whether elements can be accounted for as separate units of accounting, and if so, the fair value for each of the elements.

Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. Certain volume licensing arrangements include a perpetual license for current products combined with rights to receive unspecified future versions of software products and are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period.

Software updates are evaluated on a case-by-case basis to determine whether they meet the definition of an upgrade, which may require revenue to be deferred and recognized when the upgrade is delivered. If it is determined that implied post-contract customer support ("PCS") is being provided, revenue from the arrangement is deferred and recognized over the implied PCS term. If updates are determined to not meet the definition of an upgrade, revenue is generally recognized as products are shipped or made available.

Microsoft enters into arrangements that can include various combinations of software, services, and hardware. Where elements are delivered over different periods of time, and when allowed under U.S. GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement, and revenue is recognized as each element is delivered. We use a hierarchy to determine the fair value to be used for allocating revenue to elements: (i) vendor-specific objective evidence of fair value ("VSOE"), (ii) third-party evidence, and (iii) best estimate of selling price ("ESP"). For software elements, we follow the industry specific software guidance which only allows for the use of VSOE in establishing fair value. Generally, VSOE is the price charged when the deliverable is sold separately or the price established by management for a product that is not yet sold if it is probable that the price will not change before introduction into the marketplace. ESPs are established as best estimates of what the selling prices would be if the deliverables were sold regularly on a stand-alone basis. Our process for determining ESPs requires judgment and considers multiple factors that may vary over time depending upon the unique facts and circumstances related to each deliverable.

In January 2015, we announced Windows 10 will be free to all qualified existing users of Windows 7 and Windows 8.1. This offer differs from historical offers preceding the launch of new versions of Windows as it is being made available for free to existing users in addition to new customers after the offer announcement. We evaluated the nature and accounting treatment of the Windows 10 offer and determined that it represents a marketing and promotional activity,

in part because the offer is being made available for free to existing users. As this is a marketing and promotional activity, revenue recognition of new sales of Windows 8 will continue to be recognized as delivered.

### **Impairment of Investment Securities**

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

### **Goodwill**

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

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

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

Based on the results of our annual goodwill impairment testing as of May 1, 2015, we determined that goodwill associated with our Phone Hardware reporting unit was impaired, resulting in a material charge to earnings in the fourth quarter of fiscal year 2015. As of June 30, 2015, none of our reporting units were considered to be at risk of impairment.

### **Research and Development Costs**

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

### **Legal and Other Contingencies**

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. 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 current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our consolidated financial statements.

## **Inventories**

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

## **STATEMENT OF MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS**

Management is responsible for the preparation of the consolidated financial statements and related information that are presented in this report. The consolidated financial statements, which include amounts based on management's estimates and judgments, have been prepared in conformity with accounting principles generally accepted in the United States of America.

The Company designs and maintains accounting and internal control systems to provide reasonable assurance at reasonable cost that assets are safeguarded against loss from unauthorized use or disposition, and that the financial records are reliable for preparing consolidated financial statements and maintaining accountability for assets. These systems are augmented by written policies, an organizational structure providing division of responsibilities, careful selection and training of qualified personnel, and a program of internal audits.

The Company engaged Deloitte & Touche LLP, an independent registered public accounting firm, to audit and render an opinion on the consolidated financial statements and internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States).

The Board of Directors, through its Audit Committee, consisting solely of independent directors of the Company, meets periodically with management, internal auditors, and our independent registered public accounting firm to ensure that each is meeting its responsibilities and to discuss matters concerning internal controls and financial reporting. Deloitte & Touche LLP and the internal auditors each have full and free access to the Audit Committee.

Satya Nadella  
Chief Executive Officer

Amy E. Hood  
Executive Vice President and Chief Financial Officer

Frank H. Brod  
Corporate Vice President, Finance and Administration;  
Chief Accounting Officer

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### RISKS

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

#### **Foreign Currency**

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

#### **Interest Rate**

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

#### **Equity**

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

#### **Commodity**

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

### VALUE-AT-RISK

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

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

The following table sets forth the one-day VaR for substantially all of our positions as of June 30, 2015 and 2014 and for the year ended June 30, 2015:

(In millions)

Risk Categories	June 30, 2015	June 30, 2014	Year Ended June 30, 2015		
			Average	High	Low
Foreign currency	\$ 120	\$ 179	\$ 162	\$ 200	\$ 107
Interest rate	\$ 51	\$ 73	\$ 57	\$ 74	\$ 48
Equity	\$ 149	\$ 176	\$ 161	\$ 178	\$ 146
Commodity	\$ 13	\$ 17	\$ 16	\$ 20	\$ 11

Total one-day VaR for the combined risk categories was \$237 million at June 30, 2015 and \$333 million at June 30, 2014. The total VaR is 29% less at June 30, 2015, and 25% less at June 30, 2014, than the sum of the separate risk categories in the table above due to the diversification benefit of the combination of risks.

# FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,	2015	2014	2013
Revenue	<b>\$ 93,580</b>	\$ 86,833	\$ 77,849
Cost of revenue	<b>33,038</b>	27,078	20,385
Gross margin	<b>60,542</b>	59,755	57,464
Research and development	<b>12,046</b>	11,381	10,411
Sales and marketing	<b>15,713</b>	15,811	15,276
General and administrative	<b>4,611</b>	4,677	5,013
Impairment, integration, and restructuring	<b>10,011</b>	127	0
Operating income	<b>18,161</b>	27,759	26,764
Other income, net	<b>346</b>	61	288
Income before income taxes	<b>18,507</b>	27,820	27,052
Provision for income taxes	<b>6,314</b>	5,746	5,189
Net income	<b>\$ 12,193</b>	\$ 22,074	\$ 21,863
Earnings per share:			
Basic	<b>\$ 1.49</b>	\$ 2.66	\$ 2.61
Diluted	<b>\$ 1.48</b>	\$ 2.63	\$ 2.58
Weighted average shares outstanding:			
Basic	<b>8,177</b>	8,299	8,375
Diluted	<b>8,254</b>	8,399	8,470
Cash dividends declared per common share	<b>\$ 1.24</b>	\$ 1.12	\$ 0.92

See accompanying notes.

## COMPREHENSIVE INCOME STATEMENTS

(In millions)

Year Ended June 30,	2015	2014	2013
Net income	<u>\$ 12,193</u>	<u>\$ 22,074</u>	<u>\$ 21,863</u>
Other comprehensive income (loss):			
Net unrealized gains (losses) on derivatives (net of tax effects of <b>\$20</b> , \$(4), and \$(14))	<b>559</b>	(35)	(26)
Net unrealized gains (losses) on investments (net of tax effects of <b>\$(197)</b> , \$936, and \$195)	<b>(362)</b>	1,737	363
Translation adjustments and other (net of tax effects of <b>\$16</b> , \$12, and \$(8))	<b>(1,383)</b>	263	(16)
Other comprehensive income (loss)	<u><b>(1,186)</b></u>	<u>1,965</u>	<u>321</u>
Comprehensive income	<u><b>\$ 11,007</b></u>	<u>\$ 24,039</u>	<u>\$ 22,184</u>

See accompanying notes.

## BALANCE SHEETS

(In millions)

June 30,	2015	2014
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 5,595	\$ 8,669
Short-term investments (including securities loaned of \$75 and \$541)	90,931	77,040
Total cash, cash equivalents, and short-term investments	96,526	85,709
Accounts receivable, net of allowance for doubtful accounts of \$335 and \$301	17,908	19,544
Inventories	2,902	2,660
Deferred income taxes	1,915	1,941
Other	5,461	4,392
Total current assets	124,712	114,246
Property and equipment, net of accumulated depreciation of \$17,606 and \$14,793	14,731	13,011
Equity and other investments	12,053	14,597
Goodwill	16,939	20,127
Intangible assets, net	4,835	6,981
Other long-term assets	2,953	3,422
Total assets	<u>\$ 176,223</u>	<u>\$ 172,384</u>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 6,591	\$ 7,432
Short-term debt	4,985	2,000
Current portion of long-term debt	2,499	0
Accrued compensation	5,096	4,797
Income taxes	606	782
Short-term unearned revenue	23,223	23,150
Securities lending payable	92	558
Other	6,766	6,906
Total current liabilities	49,858	45,625
Long-term debt	27,808	20,645
Long-term unearned revenue	2,095	2,008
Deferred income taxes	2,835	2,728
Other long-term liabilities	13,544	11,594
Total liabilities	96,140	82,600
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding 8,027 and 8,239	68,465	68,366
Retained earnings	9,096	17,710
Accumulated other comprehensive income	2,522	3,708
Total stockholders' equity	80,083	89,784
Total liabilities and stockholders' equity	<u>\$ 176,223</u>	<u>\$ 172,384</u>

See accompanying notes.

## CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30,	2015	2014	2013
<b>Operations</b>			
Net income	\$ 12,193	\$ 22,074	\$ 21,863
Adjustments to reconcile net income to net cash from operations:			
Goodwill and asset impairments	7,498	0	0
Depreciation, amortization, and other	5,957	5,212	3,755
Stock-based compensation expense	2,574	2,446	2,406
Net recognized losses (gains) on investments and derivatives	(443)	(109)	80
Excess tax benefits from stock-based compensation	(588)	(271)	(209)
Deferred income taxes	224	(331)	(19)
Deferral of unearned revenue	45,072	44,325	44,253
Recognition of unearned revenue	(44,920)	(41,739)	(41,921)
Changes in operating assets and liabilities:			
Accounts receivable	1,456	(1,120)	(1,807)
Inventories	(272)	(161)	(802)
Other current assets	62	(29)	(129)
Other long-term assets	346	(628)	(478)
Accounts payable	(1,054)	473	537
Other current liabilities	(624)	1,075	146
Other long-term liabilities	1,599	1,014	1,158
Net cash from operations	29,080	32,231	28,833
<b>Financing</b>			
Proceeds from issuance of short-term debt, maturities of 90 days or less, net	4,481	500	0
Proceeds from issuance of debt	10,680	10,350	4,883
Repayments of debt	(1,500)	(3,888)	(1,346)
Common stock issued	634	607	931
Common stock repurchased	(14,443)	(7,316)	(5,360)
Common stock cash dividends paid	(9,882)	(8,879)	(7,455)
Excess tax benefits from stock-based compensation	588	271	209
Other	362	(39)	(10)
Net cash used in financing	(9,080)	(8,394)	(8,148)
<b>Investing</b>			
Additions to property and equipment	(5,944)	(5,485)	(4,257)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(3,723)	(5,937)	(1,584)
Purchases of investments	(98,729)	(72,690)	(75,396)
Maturities of investments	15,013	5,272	5,130
Sales of investments	70,848	60,094	52,464
Securities lending payable	(466)	(87)	(168)
Net cash used in investing	(23,001)	(18,833)	(23,811)
Effect of exchange rates on cash and cash equivalents	(73)	(139)	(8)
Net change in cash and cash equivalents	(3,074)	4,865	(3,134)
Cash and cash equivalents, beginning of period	8,669	3,804	6,938
Cash and cash equivalents, end of period	\$ 5,595	\$ 8,669	\$ 3,804

See accompanying notes.

## STOCKHOLDERS' EQUITY STATEMENTS

(In millions)

Year Ended June 30,	2015	2014	2013
<b>Common stock and paid-in capital</b>			
Balance, beginning of period	\$ 68,366	\$ 67,306	\$ 65,797
Common stock issued	634	607	920
Common stock repurchased	(3,700)	(2,328)	(2,014)
Stock-based compensation expense	2,574	2,446	2,406
Stock-based compensation income tax benefits	588	272	190
Other, net	3	63	7
Balance, end of period	<b>68,465</b>	68,366	67,306
<b>Retained earnings</b>			
Balance, beginning of period	17,710	9,895	(856)
Net income	12,193	22,074	21,863
Common stock cash dividends	(10,063)	(9,271)	(7,694)
Common stock repurchased	(10,744)	(4,988)	(3,418)
Balance, end of period	<b>9,096</b>	17,710	9,895
<b>Accumulated other comprehensive income</b>			
Balance, beginning of period	3,708	1,743	1,422
Other comprehensive income (loss)	(1,186)	1,965	321
Balance, end of period	<b>2,522</b>	3,708	1,743
Total stockholders' equity	<b>\$ 80,083</b>	\$ 89,784	\$ 78,944

See accompanying notes.

## NOTES TO FINANCIAL STATEMENTS

### NOTE 1 — ACCOUNTING POLICIES

#### **Accounting Principles**

The consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”).

We have recast certain prior period amounts to conform to the current period presentation, with no impact on consolidated net income or cash flows.

#### **Principles of Consolidation**

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

#### **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 include: loss contingencies; product warranties; the fair value of, and/or potential impairment of goodwill and intangibles assets, for our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; allowances for product returns; the market value of our inventory; and stock-based compensation forfeiture rates. Examples of assumptions include: the elements comprising a software arrangement, including the distinction between upgrades or enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our consolidated financial statements or tax returns; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management’s estimates and assumptions.

#### **Foreign Currencies**

Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the year. Translation adjustments resulting from this process are recorded to other comprehensive income (“OCI”).

#### **Revenue Recognition**

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is probable. Revenue generally is recognized net of allowances for returns and any taxes collected from customers and subsequently remitted to governmental authorities.

Revenue recognition for multiple-element arrangements requires judgment to determine if multiple elements exist, whether elements can be accounted for as separate units of accounting, and if so, the fair value for each of the elements.

Microsoft enters into arrangements that can include various combinations of software, services, and hardware. Where elements are delivered over different periods of time, and when allowed under U.S. GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement, and revenue is recognized as each element is delivered. We use a hierarchy to determine the fair value to be used for allocating revenue to elements: (i) vendor-specific objective evidence of fair value (“VSOE”), (ii) third-party evidence, and (iii) best estimate of selling price (“ESP”). For software elements, we follow the industry specific software guidance which only allows for the use of VSOE in establishing fair value. Generally, VSOE is the price charged when the deliverable is sold separately or the price established by management for a product that is not yet sold if it is probable that the price will not change before introduction into the marketplace. ESPs are established as best estimates of what the selling prices would be if the deliverables were sold regularly on a stand-alone basis. Our process for determining ESPs requires judgment and considers multiple factors that may vary over time depending upon the unique facts and circumstances related to each deliverable.

Revenue for retail packaged products, products licensed to original equipment manufacturers (“OEMs”), and perpetual licenses under certain volume licensing programs generally is recognized as products are shipped or made available.

Technology guarantee programs are accounted for as multiple-element arrangements as customers receive free or significantly discounted rights to use upcoming new versions of a software product if they license existing versions of the product during the eligibility period. Revenue is allocated between the existing product and the new product, and revenue allocated to the new product is deferred until that version is delivered. The revenue allocation is based on the VSOE of fair value of the products. The VSOE of fair value for upcoming new products are based on the price determined by management having the relevant authority when the element is not yet sold separately, but is expected to be sold in the near future at the price set by management.

Software updates that will be provided free of charge are evaluated on a case-by-case basis to determine whether they meet the definition of an upgrade and create a multiple-element arrangement, which may require revenue to be deferred and recognized when the upgrade is delivered, or if it is determined that implied post-contract customer support (“PCS”) is being provided, the arrangement is accounted for as a multiple-element arrangement and all revenue from the arrangement is deferred and recognized over the implied PCS term when the VSOE of fair value does not exist. If updates are determined to not meet the definition of an upgrade, revenue is generally recognized as products are shipped or made available.

Certain volume licensing arrangements include a perpetual license for current products combined with rights to receive unspecified future versions of software products, which we have determined are additional software products and are therefore accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period. Arrangements that include term-based licenses for current products with the right to use unspecified future versions of the software during the coverage period, are also accounted for as subscriptions, with revenue recognized ratably over the coverage period.

Revenue from cloud-based services arrangements that allow for the use of a hosted software product or service over a contractually determined period of time without taking possession of software are accounted for as subscriptions with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period beginning on the date the service is made available to customers. Revenue from cloud-based services arrangements that are provided on a consumption basis (for example, the amount of storage used in a particular period) is recognized commensurate with the customer utilization of such resources.

Some volume licensing arrangements include time-based subscriptions for cloud-based services and software offerings that are accounted for as subscriptions. These arrangements are considered multiple-element arrangements. However, because all elements are accounted for as subscriptions and have the same coverage period and delivery pattern, they have the same revenue recognition timing.

Revenue related to phones, Surface devices, Xbox consoles, games published by us, and other hardware components is generally recognized when ownership is transferred to the resellers or to end customers when selling directly through Microsoft retail stores and online marketplaces. A portion of revenue may be deferred when these products are combined with software elements, and/or services. Revenue related to licensing for games published by third parties for use on the Xbox consoles is recognized when games are manufactured by the game publishers.

Display advertising revenue is recognized as advertisements are displayed. Search advertising revenue is recognized when the ad appears in the search results or when the action necessary to earn the revenue has been completed. Consulting services revenue is recognized as services are rendered, generally based on the negotiated hourly rate in the consulting arrangement and the number of hours worked during the period. Consulting revenue for fixed-price services arrangements is recognized as services are provided. Revenue from prepaid points redeemable for the purchase of software or services is recognized upon redemption of the points and delivery of the software or services.

## **Cost of Revenue**

Cost of revenue includes: manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our websites, and to acquire online advertising space; costs incurred to support and maintain Internet-based products and services, including datacenter costs and royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized software development costs. Capitalized software development costs are amortized over the estimated lives of the products.

## **Product Warranty**

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

## **Research and Development**

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. Such costs related to software development are included in research and development expense until the point that technological feasibility is reached, which for our software products, is generally shortly before the products are released to manufacturing. Once technological feasibility is reached, such costs are capitalized and amortized to cost of revenue over the estimated lives of the products.

## **Sales and Marketing**

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. Advertising costs are expensed as incurred. Advertising expense was \$1.9 billion, \$2.3 billion, and \$2.6 billion in fiscal years 2015, 2014, and 2013, respectively.

## **Stock-Based Compensation**

We measure stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense, net of estimated forfeitures, over the vesting or service period, as applicable, of the stock award (generally four to five years) using the straight-line method.

## **Employee Stock Purchase Plan**

Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value of the stock on the last day of each three-month period. Compensation expense for the employee stock purchase plan is measured as the discount the employee is entitled to upon purchase and is recognized in the period of purchase.

## **Income Taxes**

Income tax expense includes U.S. and international income taxes, the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested, and interest and penalties on uncertain tax positions. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. Deferred tax assets are reported net of a valuation allowance when it is more likely than not that a tax benefit will not be realized. The deferred income taxes are classified as current or long-term based on the classification of the related asset or liability.

## **Fair Value Measurements**

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

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

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

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

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

## **Financial Instruments**

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. All cash equivalents and short-term investments are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in market value, excluding other-than-temporary impairments, are reflected in OCI.

Equity and other investments classified as long-term include both debt and equity instruments. With the exception of certain corporate notes that are classified as held-to-maturity, debt and publicly-traded equity securities are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in the market value of available-for-sale securities, excluding other-than-temporary impairments, are reflected in OCI. Held-to-maturity investments are recorded and held at amortized cost. Common and preferred stock and other investments that are restricted for more than one year or are not publicly traded are recorded at cost or using the equity method.

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

Investments are considered to be 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, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed-income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to

be other-than-temporary, an impairment charge is recorded to other income (expense), net and a new cost basis in the investment is established.

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

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

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

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

### Allowance for Doubtful Accounts

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

(In millions)

Year Ended June 30,	2015	2014	2013
Balance, beginning of period	\$ 301	\$ 336	\$ 389
Charged to costs and other	77	16	4
Write-offs	(43)	(51)	(57)
Balance, end of period	\$ 335	\$ 301	\$ 336

### Inventories

Inventories are stated at average cost, subject to the lower of cost or market. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. 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. The determination of market value and the estimated volume of demand used in the lower of cost or market analysis require significant judgment.

### Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the lease term. The estimated useful lives of our property and equipment are generally as follows: computer software developed or acquired for internal use, three to seven years; computer equipment, two to three years; buildings and improvements, five to 15 years; leasehold improvements, three to 20 years; and furniture and equipment, one to 10 years. Land is not depreciated.

### Goodwill

Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value.

## Intangible Assets

All of our intangible assets are subject to amortization and are amortized using the straight-line method over their estimated period of benefit, ranging from one to 15 years. We evaluate the recoverability of intangible assets periodically by taking into account events or circumstances that may warrant revised estimates of useful lives or that indicate the asset may be impaired.

## Recent Accounting Guidance Not Yet Adopted

In May 2014, as part of its ongoing efforts to assist in the convergence of U.S. GAAP and International Financial Reporting Standards, the Financial Accounting Standards Board (“FASB”) issued a new standard related to revenue recognition. Under the new standard, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration which the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The new standard will be effective for us beginning July 1, 2018, and adoption as of the original effective date of July 1, 2017 is permitted. We anticipate this standard will have a material impact on our consolidated financial statements, and we are currently evaluating its impact.

## 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 earnings per share)

Year Ended June 30,	2015	2014	2013
Net income available for common shareholders (A)	\$ 12,193	\$ 22,074	\$ 21,863
Weighted average outstanding shares of common stock (B)	8,177	8,299	8,375
Dilutive effect of stock-based awards	77	100	95
Common stock and common stock equivalents (C)	<u>8,254</u>	<u>8,399</u>	<u>8,470</u>
<b>Earnings Per Share</b>			
Basic (A/B)	\$ 1.49	\$ 2.66	\$ 2.61
Diluted (A/C)	\$ 1.48	\$ 2.63	\$ 2.58

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

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

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

(In millions)

Year Ended June 30,	2015	2014	2013
Dividends and interest income	\$ 766	\$ 883	\$ 677
Interest expense	(781)	(597)	(429)
Net recognized gains on investments	716	437	116
Net losses on derivatives	(423)	(328)	(196)
Net gains (losses) on foreign currency remeasurements	335	(165)	(74)
Other	(267)	(169)	194
Total	<u>\$ 346</u>	<u>\$ 61</u>	<u>\$ 288</u>

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

(In millions)

Year Ended June 30,	2015	2014	2013
Other-than-temporary impairments of investments	\$ (183)	\$ (106)	\$ (208)
Realized gains from sales of available-for-sale securities	1,176	776	489
Realized losses from sales of available-for-sale securities	(277)	(233)	(165)
Total	<u>\$ 716</u>	<u>\$ 437</u>	<u>\$ 116</u>

#### NOTE 4 — INVESTMENTS

##### Investment Components

The components of investments, including associated derivatives, but excluding held-to-maturity investments, were as follows:

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
<b>June 30, 2015</b>							
Cash	\$ 3,679	\$ 0	\$ 0	\$ 3,679	\$ 3,679	\$ 0	\$ 0
Mutual funds	1,100	0	0	1,100	1,100	0	0
Commercial paper	1	0	0	1	1	0	0
Certificates of deposit	906	0	0	906	776	130	0
U.S. government and agency securities	72,843	76	(30)	72,889	39	72,850	0
Foreign government bonds	5,477	3	(24)	5,456	0	5,456	0
Mortgage- and asset-backed securities	4,899	23	(6)	4,916	0	4,916	0
Corporate notes and bonds	7,192	97	(37)	7,252	0	7,252	0
Municipal securities	285	35	(1)	319	0	319	0
Common and preferred stock	6,668	4,986	(215)	11,439	0	0	11,439
Other investments	597	0	0	597	0	8	589
Total	<u>\$ 103,647</u>	<u>\$ 5,220</u>	<u>\$ (313)</u>	<u>\$ 108,554</u>	<u>\$ 5,595</u>	<u>\$ 90,931</u>	<u>\$ 12,028</u>

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
<b>June 30, 2014</b>							
Cash	\$ 4,980	\$ 0	\$ 0	\$ 4,980	\$ 4,980	\$ 0	\$ 0
Mutual funds	590	0	0	590	590	0	0
Commercial paper	189	0	0	189	89	100	0
Certificates of deposit	1,197	0	0	1,197	865	332	0
U.S. government and agency securities	66,952	103	(29)	67,026	109	66,917	0
Foreign government bonds	3,328	17	(10)	3,335	2,027	1,308	0
Mortgage- and asset-backed securities	991	30	(2)	1,019	0	1,019	0
Corporate notes and bonds	6,845	191	(9)	7,027	9	7,018	0
Municipal securities	287	45	0	332	0	332	0
Common and preferred stock	6,785	5,207	(81)	11,911	0	0	11,911
Other investments	1,164	0	0	1,164	0	14	1,150
<b>Total</b>	<b>\$ 93,308</b>	<b>\$ 5,593</b>	<b>\$ (131)</b>	<b>\$ 98,770</b>	<b>\$ 8,669</b>	<b>\$ 77,040</b>	<b>\$ 13,061</b>

In addition to the investments in the table above, we also own corporate notes that are classified as held-to-maturity investments, which are included in equity and other investments on the balance sheet. These corporate notes are due October 31, 2023 and are measured at fair value on a nonrecurring basis. As of June 30, 2015, the amortized cost and recorded basis of these corporate notes were both \$25 million with an estimated fair value that approximates the carrying value. As of June 30, 2014, the amortized cost, recorded basis, and estimated fair value of these corporate notes was \$1.5 billion, \$1.5 billion, and \$1.7 billion, respectively, while their associated gross unrealized holding gains were \$164 million.

As of June 30, 2015 and 2014, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were \$561 million and \$520 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

We lend certain fixed-income and equity securities to increase investment returns. These transactions are accounted for as secured borrowings and the loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. As of June 30, 2015, collateral received under these agreements totaled \$92 million which is comprised of \$79 million of certificates of deposit and \$13 million of U.S. government and agency securities. The contractual maturities of these agreements are primarily on a continuous and overnight basis.

## Unrealized Losses on Investments

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

(In millions)	Less than 12 Months		12 Months or Greater		Total Fair Value	Total Unrealized Losses
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		
<b>June 30, 2015</b>						
U.S. government and agency securities	\$ 6,636	\$ (9)	\$ 421	\$ (21)	\$ 7,057	\$ (30)
Foreign government bonds	4,611	(12)	18	(12)	4,629	(24)
Mortgage- and asset-backed securities	3,171	\$ (5)	28	(1)	3,199	(6)
Corporate notes and bonds	2,946	(29)	104	(8)	3,050	(37)
Municipal securities	36	(1)	0	0	36	(1)
Common and preferred stock	1,389	(180)	148	(35)	1,537	(215)
Total	<u>\$ 18,789</u>	<u>\$ (236)</u>	<u>\$ 719</u>	<u>\$ (77)</u>	<u>\$ 19,508</u>	<u>\$ (313)</u>

(In millions)	Less than 12 Months		12 Months or Greater		Total Fair Value	Total Unrealized Losses
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		
<b>June 30, 2014</b>						
U.S. government and agency securities	\$ 4,161	\$ (29)	\$ 850	\$ 0	\$ 5,011	\$ (29)
Foreign government bonds	566	(4)	21	(6)	587	(10)
Mortgage- and asset-backed securities	120	0	61	(2)	181	(2)
Corporate notes and bonds	1,154	(8)	34	(1)	1,188	(9)
Common and preferred stock	463	(48)	257	(33)	720	(81)
Total	<u>\$ 6,464</u>	<u>\$ (89)</u>	<u>\$ 1,223</u>	<u>\$ (42)</u>	<u>\$ 7,687</u>	<u>\$ (131)</u>

Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from domestic and international equities are due to market price movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of June 30, 2015.

## Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
<b>June 30, 2015</b>		
Due in one year or less	\$ 53,616	\$ 53,645
Due after one year through five years	33,260	33,336
Due after five years through 10 years	3,180	3,161
Due after 10 years	1,547	1,597
Total	<u>\$ 91,603</u>	<u>\$ 91,739</u>

## NOTE 5 — DERIVATIVES

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

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

## Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, Canadian dollar, and Australian dollar. As of June 30, 2015 and June 30, 2014, the total notional amounts of these foreign exchange contracts sold were \$9.8 billion and \$4.9 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of June 30, 2015 and June 30, 2014, the total notional amounts of these foreign exchange contracts sold were \$5.3 billion and \$3.1 billion, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures. As of June 30, 2015, the total notional amounts of these foreign exchange contracts purchased and sold were \$9.7 billion and \$11.0 billion, respectively. As of June 30, 2014, the total notional amounts of these foreign exchange contracts purchased and sold were \$6.2 billion and \$8.5 billion, respectively.

## Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of June 30, 2015, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$2.2 billion and \$2.6 billion, respectively, of which \$1.1 billion and \$1.4 billion, respectively, were designated as hedging instruments. As of June 30, 2014, the total notional amounts of equity contracts purchased and sold for managing market price risk were \$1.9 billion and \$1.9 billion, respectively, of which \$362 million and \$420 million, respectively, were designated as hedging instruments.

## Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of June 30, 2015, the total notional amounts of fixed-interest rate contracts purchased and sold were \$1.0 billion and \$3.2 billion, respectively. As of June 30, 2014, the total notional amounts of fixed-interest rate contracts purchased and sold were \$1.7 billion and \$936 million, respectively.

In addition, we use "To Be Announced" forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of June 30, 2015 and 2014, the total notional derivative amounts of mortgage contracts purchased were \$812 million and \$1.1 billion, respectively.

## Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low-cost method of managing exposure to individual credit risks or groups of credit risks. As of June 30, 2015, the total notional amounts of credit contracts purchased and sold were \$618 million and \$430 million, respectively. As of June 30, 2014, the total notional amounts of credit contracts purchased and sold were \$550 million and \$440 million, respectively.

## Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swaps, futures, and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of June 30, 2015, the total notional amounts of commodity contracts purchased and sold were \$882 million and \$316

million, respectively. As of June 30, 2014, the total notional amounts of commodity contracts purchased and sold were \$1.4 billion and \$408 million, respectively.

### **Credit-Risk-Related Contingent Features**

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain minimum liquidity of \$1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of June 30, 2015, our long-term unsecured debt rating was AAA, and cash investments were in excess of \$1.0 billion. As a result, no collateral was required to be posted.

## Fair Values of Derivative Instruments

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

(In millions)	June 30, 2015				June 30, 2014			
			Assets	Liabilities			Assets	Liabilities
	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities
<b>Non-designated Hedge Derivatives</b>								
Foreign exchange contracts	\$ 17	\$ 167	\$ 0	\$ (79)	\$ 10	\$ 39	\$ 0	\$ (97)
Equity contracts	148	0	0	(18)	177	0	0	(21)
Interest rate contracts	7	0	0	(12)	17	0	0	(12)
Credit contracts	16	0	0	(9)	24	0	0	(13)
Commodity contracts	0	0	0	0	15	0	0	(1)
Total	<u>\$ 188</u>	<u>\$ 167</u>	<u>\$ 0</u>	<u>\$ (118)</u>	<u>\$ 243</u>	<u>\$ 39</u>	<u>\$ 0</u>	<u>\$ (144)</u>
<b>Designated Hedge Derivatives</b>								
Foreign exchange contracts	\$ 56	\$ 552	\$ 0	\$ (31)	\$ 1	\$ 70	\$ 0	\$ (15)
Equity contracts	0	0	25	(69)	0	0	7	(125)
Total	<u>\$ 56</u>	<u>\$ 552</u>	<u>\$ 25</u>	<u>\$ (100)</u>	<u>\$ 1</u>	<u>\$ 70</u>	<u>\$ 7</u>	<u>\$ (140)</u>
Total gross amounts of derivatives	<u>\$ 244</u>	<u>\$ 719</u>	<u>\$ 25</u>	<u>\$ (218)</u>	<u>\$ 244</u>	<u>\$ 109</u>	<u>\$ 7</u>	<u>\$ (284)</u>
Gross derivatives either offset or subject to an enforceable master netting agreement	\$ 126	\$ 719	\$ 25	\$ (218)	\$ 99	\$ 109	\$ 7	\$ (284)
Gross amounts of derivatives offset in the balance sheet	(66)	(71)	(25)	161	(77)	(71)	(7)	155
Net amounts presented in the balance sheet	60	648	0	(57)	22	38	0	(129)
Gross amounts of derivatives not offset in the balance sheet	0	0	0	0	0	0	0	0
Cash collateral received	0	0	0	(456)	0	0	0	0
Net amount	<u>\$ 60</u>	<u>\$ 648</u>	<u>\$ 0</u>	<u>\$ (513)</u>	<u>\$ 22</u>	<u>\$ 38</u>	<u>\$ 0</u>	<u>\$ (129)</u>

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

### 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)

Year Ended June 30,	2015	2014	2013
<b>Foreign Exchange Contracts</b>			
Derivatives	\$ 741	\$ (14)	\$ 70
Hedged items	\$ (725)	6	(69)
Total amount of ineffectiveness	<u>\$ 16</u>	<u>\$ (8)</u>	<u>\$ 1</u>
<b>Equity Contracts</b>			
Derivatives	\$ (107)	\$ (110)	\$ 0
Hedged items	107	110	0
Total amount of ineffectiveness	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
Amount of equity contracts excluded from effectiveness assessment	\$ 0	\$ (9)	\$ 0

### Cash Flow Hedge Gains (Losses)

We recognized the following gains (losses) on foreign exchange contracts designated as cash flow hedges (our only cash flow hedges during the periods presented):

(In millions)

Year Ended June 30,	2015	2014	2013
<b>Effective Portion</b>			
Gains recognized in OCI (net of tax effects of \$35, \$2 and \$54)	\$ 1,152	\$ 63	\$ 101
Gains reclassified from AOCI into revenue	\$ 608	\$ 104	\$ 195
<b>Amount Excluded from Effectiveness Assessment and Ineffective Portion</b>			
Losses recognized in other income (expense), net	\$ (346)	\$ (239)	\$ (168)

We estimate that \$492 million of net derivative gains included in AOCI at June 30, 2015 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during fiscal year 2015.

### Non-Designated Derivative Gains (Losses)

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

(In millions)

Year Ended June 30,	2015	2014	2013
Foreign exchange contracts	\$ (483)	\$ (78)	\$ 18
Equity contracts	(19)	(64)	16
Interest-rate contracts	23	24	(11)
Credit contracts	(1)	13	(3)
Commodity contracts	(223)	71	(42)
Total	<u>\$ (703)</u>	<u>\$ (34)</u>	<u>\$ (22)</u>

NOTE 6 — FAIR VALUE MEASUREMENTS

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

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

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting <sup>(a)</sup>	Net Fair Value
<b>June 30, 2015</b>						
<b>Assets</b>						
Mutual funds	\$ 1,100	\$ 0	\$ 0	\$ 1,100	\$ 0	\$ 1,100
Commercial paper	0	1	0	1	0	1
Certificates of deposit	0	906	0	906	0	906
U.S. government and agency securities	71,930	955	0	72,885	0	72,885
Foreign government bonds	131	5,299	0	5,430	0	5,430
Mortgage- and asset-backed securities	0	4,917	0	4,917	0	4,917
Corporate notes and bonds	0	7,108	1	7,109	0	7,109
Municipal securities	0	319	0	319	0	319
Common and preferred stock	8,585	2,277	14	10,876	0	10,876
Derivatives	4	979	5	988	(162)	826
<b>Total</b>	<b>\$ 81,750</b>	<b>\$ 22,761</b>	<b>\$ 20</b>	<b>\$ 104,531</b>	<b>\$ (162)</b>	<b>\$ 104,369</b>
<b>Liabilities</b>						
Derivatives and other	\$ 5	\$ 159	\$ 54	\$ 218	\$ (161)	\$ 57

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting <sup>(a)</sup>	Net Fair Value
<b>June 30, 2014</b>						
<b>Assets</b>						
Mutual funds	\$ 590	\$ 0	\$ 0	\$ 590	\$ 0	\$ 590
Commercial paper	0	189	0	189	0	189
Certificates of deposit	0	1,197	0	1,197	0	1,197
U.S. government and agency securities	66,288	745	0	67,033	0	67,033
Foreign government bonds	139	3,210	0	3,349	0	3,349
Mortgage- and asset-backed securities	0	1,015	0	1,015	0	1,015
Corporate notes and bonds	0	6,863	0	6,863	0	6,863
Municipal securities	0	332	0	332	0	332
Common and preferred stock	9,552	1,825	14	11,391	0	11,391
Derivatives	5	348	7	360	(155)	205
<b>Total</b>	<b>\$ 76,574</b>	<b>\$ 15,724</b>	<b>\$ 21</b>	<b>\$ 92,319</b>	<b>\$ (155)</b>	<b>\$ 92,164</b>
<b>Liabilities</b>						
Derivatives and other	\$ 5	\$ 153	\$ 126	\$ 284	\$ (155)	\$ 129

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

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

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

(In millions)

June 30,	2015	2014
Net fair value of assets measured at fair value on a recurring basis	\$ 104,369	\$ 92,164
Cash	3,679	4,980
Common and preferred stock measured at fair value on a nonrecurring basis	561	520
Other investments measured at fair value on a nonrecurring basis	589	1,150
Less derivative net assets classified as other current assets	(648)	(38)
Other	4	(6)
Recorded basis of investment components	<u>\$ 108,554</u>	<u>\$ 98,770</u>

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

During fiscal year 2015 and 2014, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

### NOTE 7 — INVENTORIES

The components of inventories were as follows:

(In millions)

June 30,	2015	2014
Raw materials	\$ 1,100	\$ 944
Work in process	202	266
Finished goods	1,600	1,450
Total	<u>\$ 2,902</u>	<u>\$ 2,660</u>

### NOTE 8 — PROPERTY AND EQUIPMENT

The components of property and equipment were as follows:

(In millions)

June 30,	2015	2014
Land	\$ 769	\$ 541
Buildings and improvements	10,800	8,867
Leasehold improvements	3,577	3,560
Computer equipment and software	13,612	11,430
Furniture and equipment	3,579	3,406
Total, at cost	<u>32,337</u>	<u>27,804</u>
Accumulated depreciation	<u>(17,606)</u>	<u>(14,793)</u>
Total, net	<u>\$ 14,731</u>	<u>\$ 13,011</u>

During fiscal years 2015, 2014, and 2013, depreciation expense was \$4.1 billion, \$3.4 billion, and \$2.6 billion, respectively.

### NOTE 9 — BUSINESS COMBINATIONS

#### Mojang Synergies AB

On November 6, 2014, we acquired Mojang Synergies AB (“Mojang”), the Swedish video game developer of the Minecraft gaming franchise, for \$2.5 billion in cash, net of cash acquired. The addition of Minecraft and its community enhances our gaming portfolio across Windows, Xbox, and other ecosystems besides our own. Our purchase price

allocation is preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available, including additional information relating to tax matters and finalization of our valuation of identified intangible assets.

The significant classes of assets and liabilities to which we preliminarily allocated the purchase price were goodwill of \$1.8 billion and identifiable intangible assets of \$928 million, primarily marketing-related (trade names). 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 Devices and Consumer (“D&C”) Other segment. Identifiable intangible assets were assigned a total weighted-average amortization period of 6.3 years. Mojang has been included in our consolidated results of operations since the acquisition date.

### Nokia’s Devices and Services Business

On April 25, 2014, we acquired substantially all of Nokia Corporation’s (“Nokia”) Devices and Services business (“NDS”) for a total purchase price of \$9.4 billion, including cash acquired of \$1.5 billion (the “Acquisition”). The purchase price consisted primarily of cash of \$7.1 billion and Nokia’s repurchase of convertible notes of \$2.1 billion, which was a non-cash transaction, and liabilities assumed of \$0.2 billion. The Acquisition was expected to accelerate the growth of our D&C business through faster innovation, synergies, and unified branding and marketing.

The allocation of the purchase price to goodwill was completed as of March 31, 2015. The major classes of assets and liabilities to which we have allocated the purchase price were as follows:

(In millions)

Cash	\$ 1,506
Accounts receivable <sup>(a)</sup>	754
Inventories	544
Other current assets	936
Property and equipment	981
Intangible assets	4,509
Goodwill <sup>(b)</sup>	5,456
Other	221
Current liabilities	(4,575)
Long-term liabilities	(890)
<b>Total purchase price</b>	<b>\$ 9,442</b>

(a) *Gross accounts receivable was \$901 million, of which \$147 million was expected to be uncollectible.*

(b) *Goodwill was assigned to our Phone Hardware segment. The goodwill was primarily attributed to increased synergies that were expected to be achieved from the integration of NDS.*

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

(In millions)	Amount	Weighted Average Life
Technology-based	\$ 2,493	9 years
Contract-based	1,500	9 years
Customer-related	359	3 years
Marketing-related (trade names)	157	2 years
<b>Fair value of intangible assets acquired</b>	<b>\$ 4,509</b>	<b>8 years</b>

During the fourth quarter of fiscal year 2015, we recorded \$7.5 billion of goodwill and asset impairment charges related to our Phone Hardware business. These costs are included in impairment, integration, and restructuring expenses in our consolidated income statement. See Note 10 – Goodwill and Note 11 – Intangible Assets for additional details.

Our consolidated income statement for fiscal year 2014 included revenue and operating loss of \$2.0 billion and \$692 million, respectively, attributable to NDS since the Acquisition.

Following are the supplemental consolidated results of Microsoft Corporation on an unaudited pro forma basis, as if the Acquisition had been consummated on July 1, 2012:

(In millions, except per share amounts)

Year Ended June 30,	2014	2013
Revenue	\$ 96,248	\$ 93,243
Net income	\$ 20,234	\$ 20,153
Diluted earnings per share	\$ 2.41	\$ 2.38

These pro forma results were based on estimates and assumptions, which we believe are reasonable. They are not the results that would have been realized had we been a combined company during the periods presented and are not necessarily indicative of our consolidated results of operations in future periods. The pro forma results include adjustments primarily related to purchase accounting adjustments and the elimination of related party transactions between Microsoft and NDS. Acquisition costs and other nonrecurring charges incurred are included in the earliest period presented.

During the fourth quarter of fiscal year 2014, we incurred \$21 million of acquisition costs associated with the purchase of NDS. Acquisition costs are primarily comprised of transaction fees and direct acquisition costs, including legal, finance, consulting, and other professional fees. These costs are included in impairment, integration, and restructuring expenses on our consolidated income statement for fiscal year 2014.

Certain concurrent transactions were recognized separately from the Acquisition. Prior to the Acquisition, we had joint strategic initiatives with Nokia; this contractual relationship was terminated in conjunction with the Acquisition. No gain or loss was recorded upon termination of this agreement, as it was determined to be at market value. In addition, we agreed to license Nokia's mapping services and will pay Nokia separately for the services provided under a four-year license as they are rendered.

#### **Yammer**

On July 18, 2012, we acquired Yammer, Inc. ("Yammer"), a leading provider of enterprise social networks, for \$1.1 billion in cash. Yammer added an enterprise social networking service to Microsoft's portfolio of complementary cloud-based services. The major classes of assets to which we allocated the purchase price were goodwill of \$937 million and identifiable intangible assets of \$178 million. We assigned the goodwill to Commercial Other under our current segment structure. Yammer was consolidated into our results of operations starting on the acquisition date.

#### **Other**

During fiscal year 2015, we completed 15 additional acquisitions for total cash consideration of \$892 million. These entities have been included in our consolidated results of operations since their respective acquisition dates.

Pro forma results of operations for Mojang and our other acquisitions during the current period have not been presented because the effects of these business combinations, individually and in aggregate, were not material to our consolidated results of operations.

## NOTE 10 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30, 2013	Acquisitions	Other	June 30, 2014	Acquisitions	Other	June 30, 2015
Devices and Consumer Licensing	\$ 866	\$ 0	\$ 2	\$ 868	\$ 4	\$ 0	\$ 872
Hardware:							
Computing and Gaming Hardware	1,689	0	9	1,698	13	(36)	1,675
Phone Hardware	0	5,458 <sup>(a)</sup>	(104)	5,354	0	(5,238)	116
Total Devices and Consumer Hardware	1,689	5,458	(95)	7,052	13	(5,274)	1,791
Other	738	0	0	738	1,772	(195)	2,315
Total Devices and Consumer	3,293	5,458	(93)	8,658	1,789	(5,469)	4,978
Commercial Licensing	10,051	2	5	10,058	77	(170)	9,965
Other	1,311	105	(5)	1,411	589	(4)	1,996
Total Commercial	11,362	107	0	11,469	666	(174)	11,961
Total goodwill	\$ 14,655	\$ 5,565	\$ (93)	\$ 20,127	\$ 2,455	\$ (5,643)	\$ 16,939

(a) Goodwill acquired during fiscal year 2014 related to the acquisition of NDS. See Note 9 – Business Combinations for additional details.

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 recasting of the amounts allocated to goodwill retroactive to the periods in which the acquisitions occurred.

Any change in the goodwill amounts resulting from foreign currency translations and purchase accounting adjustments are presented as “Other” in the above table. Also included in “Other” are business dispositions and transfers between business segments due to reorganizations, as applicable. For fiscal year 2015, a \$5.1 billion goodwill impairment charge was included in “Other,” as discussed further below. This goodwill impairment charge was included in impairment, integration, and restructuring expenses in our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment group in Note 22 – Segment Information and Geographic Data.

Our accumulated goodwill impairment as of June 30, 2015 and 2014 was \$11.3 billion and \$6.2 billion, respectively.

### Goodwill Impairment

We test goodwill for impairment annually on May 1 at the reporting unit level, primarily using a discounted cash flow methodology with a peer-based, risk-adjusted weighted average cost of capital. We believe use of a discounted cash flow approach is the most reliable indicator of the fair values of the businesses.

Upon completion of the annual testing as of May 1, 2015, Phone Hardware goodwill was determined to be impaired. In the second half of fiscal year 2015, Phone Hardware did not meet its sales volume and revenue goals, and the mix of units sold had lower margins than planned. These results, along with changes in the competitive marketplace and an evaluation of business priorities, led to a shift in strategic direction and reduced future revenue and profitability expectations for the business. As a result of these changes in strategy and expectations, we have forecasted reductions in unit volume growth rates and lower future cash flows used to estimate the fair value of the Phone Hardware reporting unit, which resulted in the determination that an impairment adjustment was required.

Because our annual test indicated that Phone Hardware's carrying value exceeded its estimated fair value, a second phase of the goodwill impairment test ("Step 2") was performed specific to Phone Hardware. Under Step 2, the fair value of all Phone Hardware assets and liabilities were estimated, including tangible assets, existing technology, patent agreements, and contractual arrangements, for the purpose of deriving an estimate of the implied fair value of goodwill. The implied fair value of the goodwill was then compared to the recorded goodwill to determine the amount of the impairment. Assumptions used in measuring the value of these assets and liabilities included the discount rates and royalty rates used in valuing the intangible assets, and consideration of the market environment in valuing the tangible assets.

No other instances of impairment were identified in our May 1, 2015 test. No impairment of goodwill was identified as of May 1, 2014.

#### NOTE 11 — 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
<b>Year Ended June 30,</b>			<b>2015</b>			<b>2014</b>
Technology-based <sup>(a)</sup>	\$ 6,187	\$ (3,410)	\$ 2,777	\$ 6,440	\$ (2,615)	\$ 3,825
Marketing-related	1,974	(540)	1,434	1,518	(324)	1,194
Contract-based	1,344	(862)	482	2,266	(716)	1,550
Customer-related	632	(490)	142	732	(320)	412
Total	<u>\$ 10,137</u>	<u>\$ (5,302)</u>	<u>\$ 4,835</u>	<u>\$ 10,956</u>	<u>\$ (3,975)</u>	<u>\$ 6,981</u>

(a) *Technology-based intangible assets included \$116 million and \$98 million as of June 30, 2015 and 2014, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

We estimate that we have no significant residual value related to our intangible assets. During fiscal year 2015, we recorded impairment charges of \$2.2 billion related to our Phone Hardware intangible assets. In the fourth quarter of fiscal year 2015, we tested the intangible assets for recoverability due to changes in facts and circumstances associated with the shift in strategic direction and reduced profitability expectations for Phone Hardware. Based on the results of our testing, we determined that the carrying value of the intangible assets was not recoverable, and an impairment charge was recorded to the extent that estimated fair value exceeded carrying value. We primarily used a relief from royalty income approach to determine the fair value of the intangible assets and determine the amount of impairment. These intangible assets impairment charges were included in impairment, integration, and restructuring expenses in our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment group in Note 22 – Segment Information and Geographic Data. No material impairments of intangible assets were identified during fiscal year 2014.

The components of intangible assets acquired during the periods presented were as follows:

(In millions)	Amount	Weighted Average Life	Amount	Weighted Average Life
<b>Year Ended June 30,</b>			<b>2014</b>	
			<b>2015</b>	
Technology-based	\$ 874	5 years	\$ 2,841	9 years
Marketing-related	543	8 years	174	2 years
Contract-based	0		1,500	9 years
Customer-related	37	4 years	363	3 years
Total	<u>\$ 1,454</u>	<u>6 years</u>	<u>\$ 4,878</u>	<u>8 years</u>

The table above includes \$4.5 billion related to the acquisition of NDS during fiscal year 2014, of which \$2.2 billion was impaired in fiscal year 2015. See Note 9 – Business Combination for additional details.

Intangible assets amortization expense was \$1.3 billion, \$845 million, and \$739 million for fiscal years 2015, 2014, and 2013, respectively. Amortization of capitalized software was \$79 million, \$200 million, and \$210 million for fiscal years 2015, 2014, and 2013, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held at June 30, 2015:

(In millions)

Year Ending June 30,	
2016	\$ 910
2017	755
2018	670
2019	554
2020	495
Thereafter	1,451
<hr/>	
Total	<u>\$ 4,835</u>

#### NOTE 12 — DEBT

##### **Short-term Debt**

As of June 30, 2015, we had \$5.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.11% and maturities ranging from 8 days to 63 days. As of June 30, 2014, we had \$2.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.12% and maturities ranging from 86 to 91 days. The estimated fair value of this commercial paper approximates its carrying value.

We have two \$5.0 billion credit facilities that expire on November 4, 2015 and November 14, 2018, respectively. These credit facilities serve as a back-up for our commercial paper program. As of June 30, 2015, we were in compliance with the only financial covenant in both credit agreements, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreements. No amounts were drawn against these credit facilities during any of the periods presented.

##### **Long-term Debt**

As of June 30, 2015, the total carrying value and estimated fair value of our long-term debt, including the current portion, were \$30.3 billion and \$30.5 billion, respectively. This is compared to a carrying value and estimated fair value of our long-term debt of \$20.6 billion and \$21.5 billion, respectively, as of June 30, 2014. These estimated fair values are based on Level 2 inputs.

The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of June 30, 2015 and 2014:

Due Date	Face Value June 30, 2015	Face Value June 30, 2014	Stated Interest Rate	Effective Interest Rate
	(In millions)			
<b>Notes</b>				
September 25, 2015	\$ 1,750	\$ 1,750	1.625%	1.795%
February 8, 2016	750	750	2.500%	2.642%
November 15, 2017	600	600	0.875%	1.084%
May 1, 2018	450	450	1.000%	1.106%
December 6, 2018	1,250	1,250	1.625%	1.824%
June 1, 2019	1,000	1,000	4.200%	4.379%
February 12, 2020 <sup>(a)</sup>	1,500	0	1.850%	1.935%
October 1, 2020	1,000	1,000	3.000%	3.137%
February 8, 2021	500	500	4.000%	4.082%
December 6, 2021 <sup>(b)</sup>	1,950	2,396	2.125%	2.233%
February 12, 2022 <sup>(a)</sup>	1,500	0	2.375%	2.466%
November 15, 2022	750	750	2.125%	2.239%
May 1, 2023	1,000	1,000	2.375%	2.465%
December 15, 2023	1,500	1,500	3.625%	3.726%
February 12, 2025 <sup>(a)</sup>	2,250	0	2.700%	2.772%
December 6, 2028 <sup>(b)</sup>	1,950	2,396	3.125%	3.218%
May 2, 2033 <sup>(b)</sup>	613	753	2.625%	2.690%
February 12, 2035 <sup>(a)</sup>	1,500	0	3.500%	3.604%
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 <sup>(a)</sup>	1,750	0	3.750%	3.800%
February 12, 2055 <sup>(a)</sup>	2,250	0	4.000%	4.063%
Total	<u>\$ 30,463</u>	<u>\$ 20,745</u>		

(a) *In February 2015, we issued \$10.8 billion of debt securities.*

(b) *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. Cash paid for interest on our debt for fiscal years 2015, 2014, and 2013 was \$620 million, \$509 million, and \$371 million, respectively. As of June 30, 2015 and 2014, the aggregate unamortized discount for our long-term debt, including the current portion, was \$156 million and \$100 million, respectively.

### Debt Service

Maturities of our long-term debt for each of the next five years and thereafter are as follows:

(In millions)	
<b>Year Ending June 30,</b>	
2016	\$ 2,500
2017	0
2018	1,050
2019	2,250
2020	1,500
Thereafter	23,163
Total	<u>\$ 30,463</u>

## NOTE 13 — INCOME TAXES

The components of the provision for income taxes were as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
<b>Current Taxes</b>			
U.S. federal	\$ 3,661	\$ 3,738	\$ 3,131
U.S. state and local	364	266	332
Foreign	2,065	2,073	1,745
Current taxes	6,090	6,077	5,208
<b>Deferred Taxes</b>			
Deferred taxes	224	(331)	(19)
Provision for income taxes	\$ 6,314	\$ 5,746	\$ 5,189

U.S. and foreign components of income before income taxes were as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
U.S.	\$ 7,363	\$ 7,127	\$ 6,674
Foreign	11,144	20,693	20,378
Income before income taxes	\$ 18,507	\$ 27,820	\$ 27,052

The items accounting for the difference between income taxes computed at the U.S. federal statutory rate and our effective rate were as follows:

Year Ended June 30,	2015	2014	2013
Federal statutory rate	35.0%	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	(20.9)%	(17.1)%	(17.5)%
Phone Hardware nondeductible charges and valuation allowance	19.1%	0.9%	0%
Domestic production activities deduction	(2.4)%	(1.0)%	(1.2)%
Other reconciling items, net	3.3%	2.9%	2.9%
Effective rate	34.1%	20.7%	19.2%

The reduction from the federal statutory rate is primarily due to foreign earnings taxed at lower rates resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico. In fiscal year 2015, this reduction was mostly offset by losses in foreign jurisdictions for which we may not realize a tax benefit, primarily as a result of impairment and restructuring charges. Excluding these losses, our foreign earnings, which are taxed at rates lower than the U.S. rate and are generated from our regional operating centers, were 73%, 81%, and 79% of our foreign income before tax in fiscal years 2015, 2014, and 2013, respectively. In general, other reconciling items consist of interest, U.S. state income taxes, and credits. In fiscal years 2015, 2014, and 2013, there were no individually significant other reconciling items.

The components of the deferred income tax assets and liabilities were as follows:

(In millions)

June 30,	2015	2014
<b>Deferred Income Tax Assets</b>		
Stock-based compensation expense	\$ 884	\$ 903
Other expense items	1,531	1,112
Restructuring charges	211	0
Unearned revenue	520	520
Impaired investments	257	272
Loss carryforwards	1,158	922
Depreciation and amortization	798	0
Other revenue items	56	64
Deferred income tax assets	5,415	3,793
Less valuation allowance	(2,265)	(903)
Deferred income tax assets, net of valuation allowance	<u>\$ 3,150</u>	<u>\$ 2,890</u>
<b>Deferred Income Tax Liabilities</b>		
Foreign earnings	\$ (1,280)	\$ (1,140)
Unrealized gain on investments and debt	(2,223)	(1,974)
Depreciation and amortization	(685)	(470)
Other	(29)	(87)
Deferred income tax liabilities	(4,217)	(3,671)
Net deferred income tax assets (liabilities)	<u>\$ (1,067)</u>	<u>\$ (781)</u>
<b>Reported As</b>		
Current deferred income tax assets	\$ 1,915	\$ 1,941
Other current liabilities	(211)	(125)
Other long-term assets	64	131
Long-term deferred income tax liabilities	(2,835)	(2,728)
Net deferred income tax assets (liabilities)	<u>\$ (1,067)</u>	<u>\$ (781)</u>

As of June 30, 2015, we had net operating loss carryforwards of \$4.6 billion, including \$1.8 billion of foreign net operating loss carryforwards acquired through our acquisition of Skype, and \$545 million through our acquisition of NDS. The valuation allowance disclosed in the table above relates to the foreign net operating loss carryforwards and other future deductible net deferred tax assets that may not be realized.

Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases and are stated at enacted tax rates expected to be in effect when the taxes are actually paid or recovered.

As of June 30, 2015, we have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately \$108.3 billion resulting from earnings for certain non-U.S. subsidiaries which are permanently reinvested outside the U.S. The unrecognized deferred tax liability associated with these temporary differences was approximately \$34.5 billion at June 30, 2015.

Income taxes paid were \$4.4 billion, \$5.5 billion, and \$3.9 billion in fiscal years 2015, 2014, and 2013, respectively.

### Uncertain Tax Positions

Unrecognized tax benefits as of June 30, 2015, 2014, and 2013, were \$9.6 billion, \$8.7 billion, and \$8.6 billion, respectively. If recognized, these tax benefits would affect our effective tax rates for fiscal years 2015, 2014, and 2013, by \$7.9 billion, \$7.0 billion, and \$6.5 billion, respectively.

As of June 30, 2015, 2014, and 2013, we had accrued interest expense related to uncertain tax positions of \$1.7 billion, \$1.5 billion, and \$1.3 billion, respectively, net of federal income tax benefits. Interest expense on unrecognized tax

benefits was \$237 million, \$235 million, and \$400 million in fiscal years 2015, 2014, and 2013, respectively, and was included in income tax expense.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
Balance, beginning of year	\$ 8,714	\$ 8,648	\$ 7,202
Decreases related to settlements	(50)	(583)	(30)
Increases for tax positions related to the current year	1,091	566	612
Increases for tax positions related to prior years	94	217	931
Decreases for tax positions related to prior years	(144)	(95)	(65)
Decreases due to lapsed statutes of limitations	(106)	(39)	(2)
Balance, end of year	<u>\$ 9,599</u>	<u>\$ 8,714</u>	<u>\$ 8,648</u>

During the third quarter of fiscal year 2011, we reached a settlement of a portion of an I.R.S. audit of tax years 2004 to 2006, which reduced our income tax expense by \$461 million. While we settled a portion of the I.R.S. audit, we remain under audit for these years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of June 30, 2015, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2015.

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 2015, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

#### NOTE 14 — RESTRUCTURING CHARGES

##### *Phone Hardware Integration*

In July 2014, we announced a restructuring plan to simplify our organization and align NDS with our company's overall strategy (the "Phone Hardware Integration Plan"). Pursuant to the Phone Hardware Integration Plan, we eliminated approximately 19,000 positions in fiscal year 2015, including approximately 13,000 professional and factory positions related to the NDS business. The actions associated with the Phone Hardware Integration Plan were completed as of June 30, 2015.

In connection with the Phone Hardware Integration Plan, we incurred restructuring charges of \$1.3 billion during fiscal year 2015, including severance expenses and other reorganization costs, primarily associated with our facilities consolidation and write-downs of certain assets.

##### *Phone Hardware Restructuring*

In June 2015, management approved a plan to restructure our Phone Hardware business to better focus and align resources (the "Phone Hardware Restructuring Plan"), under which we will eliminate up to 7,800 positions in fiscal year 2016. In connection with the Phone Hardware Restructuring Plan, we recorded restructuring charges of \$780 million during fiscal year 2015, including severance expenses and other reorganization costs, primarily related to contractual obligations. The actions associated with the Phone Hardware Restructuring Plan are expected to be completed as of June 30, 2016.

Restructuring charges associated with each plan were included in impairment, integration, and restructuring expenses in our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment group in Note 22 – Segment Information and Geographic Data.

Changes in the restructuring liability were as follows:

(In millions)	Severance	Asset Impairments and Other <sup>(a)</sup>	Total
Restructuring liability as of June 30, 2014	\$ 0	\$ 0	\$ 0
Restructuring charges	1,308	770	2,078
Cash paid	(701)	(134)	(835)
Other	(19)	(387)	(406)
Restructuring liability as of June 30, 2015	<u>\$ 588</u>	<u>\$ 249</u>	<u>\$ 837</u>

(a) "Asset Impairments and Other" primarily reflects activities associated with the consolidation of our facilities and manufacturing operations, including asset write-downs of \$372 million during fiscal year 2015, as well as contract termination costs.

#### NOTE 15 — UNEARNED REVENUE

Unearned revenue by segment was as follows, with segments with significant balances shown separately:

(In millions)	2015	2014
June 30,		
Commercial Licensing	\$ 17,672	\$ 19,099
Commercial Other	5,641	3,934
Rest of the segments	2,005	2,125
Total	<u>\$ 25,318</u>	<u>\$ 25,158</u>

#### NOTE 16 — OTHER LONG-TERM LIABILITIES

(In millions)	2015	2014
June 30,		
Tax contingencies and other tax liabilities	\$ 12,290	\$ 10,510
Other	1,254	1,084
Total	<u>\$ 13,544</u>	<u>\$ 11,594</u>

#### NOTE 17 — COMMITMENTS AND GUARANTEES

##### **Construction and Operating Leases**

We have committed \$681 million for constructing new buildings, building improvements, and leasehold improvements as of June 30, 2015.

We have operating leases for most U.S. and international sales and support offices, research and development facilities, manufacturing facilities, retail stores, and certain equipment. Rental expense for facilities operating leases was \$989 million, \$874 million, and \$711 million, in fiscal years 2015, 2014, and 2013, respectively. Future minimum rental commitments under non-cancellable facilities operating leases in place as of June 30, 2015 are as follows:

(In millions)	
Year Ending June 30,	
2016	\$ 863
2017	803
2018	735
2019	611
2020	524
Thereafter	1,617
Total	<u>\$ 5,153</u>

## Indemnifications

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. We evaluate estimated losses for these indemnifications, and we consider such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. To date, we have not encountered significant costs as a result of these obligations and have not accrued any liabilities related to these indemnifications in our consolidated financial statements.

## NOTE 18 — CONTINGENCIES

### Patent and Intellectual Property Claims

#### *Motorola litigation*

In October 2010, Microsoft filed patent infringement complaints against Motorola Mobility (“Motorola”) with the International Trade Commission (“ITC”) and in U.S. District Court in Seattle for infringement of nine Microsoft patents by Motorola’s Android devices. Microsoft and Motorola have filed additional claims against each other with the ITC, in federal district courts in Seattle, Wisconsin, Florida, and California, and in courts in Germany. The nature of the claims asserted and status of individual matters are summarized below.

#### International Trade Commission

In 2012, the ITC issued a limited exclusion order against Motorola on one Microsoft patent, which was affirmed on appeal. In 2013, Microsoft filed an action in U.S. District Court in Washington, D.C. seeking an order to compel enforcement of the ITC’s 2012 import ban against infringing Motorola products by the Bureau of Customs and Border Protection (“CBP”), after learning that CBP had failed to fully enforce the order.

In 2010, Motorola filed an action against Microsoft with the ITC alleging infringement of five Motorola patents by Xbox consoles and accessories and seeking an exclusion order to prohibit importation of the allegedly infringing Xbox products. At Motorola’s request, the ITC terminated its investigation of four Motorola patents. In 2013, the ITC affirmed there was no violation of the remaining Motorola patent. Motorola appealed the ITC’s decision to the U.S. Court of Appeals for the Federal Circuit.

#### U.S. District Court

The Seattle District Court case filed in October 2010 by Microsoft as a companion to Microsoft’s ITC case against Motorola was stayed pending the outcome of the ITC case.

In November 2010, Microsoft sued Motorola for breach of contract in U.S. District Court in Seattle, alleging that Motorola breached its commitments to standards-setting organizations to license to Microsoft certain patents on reasonable and non-discriminatory (“RAND”) terms and conditions. Motorola has declared these patents essential to the implementation of the H.264 video standard and the 802.11 Wi-Fi standard. In the Motorola ITC case described above and in suits described below, Motorola or a Motorola affiliate subsequently sued Microsoft on those patents in U.S. District Courts, in the ITC, and in Germany. In 2012, the Seattle District Court granted a partial summary judgment in favor of Microsoft ruling that (1) Motorola had committed to standards organizations to license its declared-essential patents on RAND terms and conditions; and (2) Microsoft is a third-party beneficiary of those commitments. After trial, the Seattle District Court set per unit royalties for Motorola’s H.264 and 802.11 patents, which resulted in an immaterial Microsoft liability. In 2013, following trial of Microsoft’s breach of contract claim, a jury awarded \$14.5 million in damages to Microsoft. Motorola appealed with respect to both the Court’s determination of royalties due Motorola and the jury’s award of damages against Motorola; in July 2015 the U.S. Court of Appeals for the Ninth Circuit affirmed the trial court’s judgment in all respects.

Cases filed by Motorola in Wisconsin, California, and Florida, with the exception of one case in Wisconsin initially stayed and later dismissed without prejudice (a companion case to Motorola’s ITC action), have been transferred to the U.S. District Court in Seattle. Motorola and Microsoft both seek damages as well as injunctive relief. The court has stayed these cases in Seattle on agreement of the parties.

- In the transferred cases, Motorola asserts 15 patents are infringed by a range of Microsoft products including mobile and PC operating system, productivity, server, communication, browser and gaming products.
- In the Motorola action originally filed in California, Motorola asserts Microsoft violated antitrust laws in connection with Microsoft’s assertion of patents against Motorola that Microsoft agreed to license to certain qualifying entities on RAND terms and conditions.

- In counterclaims, Microsoft asserts 14 patents are infringed by Motorola Android devices and certain Motorola digital video recorders.

## Germany

In 2011, Motorola filed patent infringement actions in Germany against Microsoft and several Microsoft subsidiaries.

- Motorola asserts two patents (both now expired) are essential to implementation of the H.264 video standard, and Motorola alleges that H.264 capable products including Xbox 360, Windows 7, Media Player, and Internet Explorer infringe those patents. In 2012, the court issued an injunction relating to all H.264 capable Microsoft products in Germany, which Microsoft appealed. Orders in the litigation pending in Seattle, Washington described above enjoin Motorola from enforcing the German injunction.
- Motorola asserts that one patent covers certain syncing functionality in the ActiveSync protocol employed by Windows Phone 7, Outlook Mobile, Hotmail Mobile, Exchange Online, Exchange Server, and Hotmail Server. In 2013, the court stayed the case pending the outcome of parallel proceedings in which Microsoft is seeking to invalidate the patent. In 2013, the Federal Patent Court invalidated the originally issued patent claims, but ruled that certain new amended claims were patentable. Both Motorola and Microsoft appealed. In June 2014, the court reopened infringement proceedings, which are currently stayed.
- Microsoft may be able to mitigate the adverse impact of any injunction by altering its products to avoid Motorola's infringement claims.
- Any damages would be determined in separate proceedings.

In lawsuits Microsoft filed in Germany in 2011 and 2012, Microsoft asserts that Motorola Android devices infringe Microsoft patents and is seeking damages and injunctions. In 2012, regional courts in Germany issued injunctions on three of the Microsoft patents, which Motorola appealed. One judgment has been affirmed on appeal (and Motorola has further appealed), and the other two appeals are pending (in one of these two cases the asserted patent has expired). An additional infringement proceeding is still pending in the court of first instance. In actions filed separately by Motorola to invalidate these patents, the Federal Patent Court in 2013 and 2014 held the Microsoft patents invalid, and Microsoft appealed. For the cases in which Microsoft obtained injunctions, if Motorola were to prevail following all appeals, Motorola could have a claim against Microsoft for damages caused by an erroneously granted injunction.

### *IPCom patent litigation*

IPCom GmbH & Co. ("IPCom") is a German company that holds a large portfolio of mobile technology-related patents spanning about 170 patent families and addressing a broad range of cellular technologies. IPCom has asserted 19 of these patents in litigation against Nokia and many of the leading cell phone companies and operators. In November 2014, Microsoft and IPCom entered into a standstill agreement staying all of the pending litigation against Microsoft to permit the parties to pursue settlement discussions.

### *InterDigital patent litigation*

InterDigital Technology Corporation and InterDigital Communications Corporation (collectively, "IDT") filed four patent infringement cases against Nokia in the ITC and in U.S. District Court for the District of Delaware between 2007 and 2013. We have been added to these cases as a defendant. IDT has cases pending against other defendants based on the same patents because most of the patents at issue allegedly relate to 3G and 4G wireless communications standards essential functionality. The cases involving us include three ITC investigations where IDT is seeking an order excluding importation of 3G and 4G phones into the U.S. and one active case in U.S. District Court in Delaware seeking an injunction and damages. The ITC issued a finding of no violation relating to two of the investigations, which IDT appealed. In February 2015, the U.S. Court of Appeals for the Federal Circuit affirmed one of the ITC's findings; the other has been stayed. In the third ITC action the administrative law judge ("ALJ") issued a determination finding: (1) infringement; (2) evidence of "reverse hold-up;" and (3) the public interest does not preclude issuance of an exclusion order. The ITC is reviewing the ALJ's initial determination. The trial in the Delaware case is scheduled for November 2015.

### *European copyright levies*

We assumed from Nokia all potential liability due to Nokia's alleged failure to pay "private copying levies" in various European countries based upon sale of memory cards and mobile phones that incorporate blank memory. The levies are based upon a 2001 European Union ("EU") Directive establishing a right for end users to make copies of copyrighted works for personal or private use, but also allowing the collection of levies based upon sales of blank media or recording devices to compensate copyright holders for private copying. Various collecting societies in EU countries

initiated litigation against Nokia, stating that Nokia must pay levies not only based upon sales of blank memory cards, but also phones that include blank memory for data storage on the phones, regardless of actual usage of that memory. The most significant cases against Nokia are pending in Germany and Austria, due to both the high volume of sales and high levy amounts sought in these countries. Since April 2015, we and other major manufacturers have been engaged in settlement negotiations with the German collecting society, with the aim of concluding negotiations by October 2015.

#### *Other patent and intellectual property claims*

In addition to these cases, there are approximately 70 other patent infringement cases pending against Microsoft.

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

A large number of antitrust and unfair competition class action lawsuits were filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products between 1999 and 2005.

We obtained dismissals or reached settlements of all claims made in the U.S. Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. We estimate the total remaining cost of the settlements is approximately \$200 million, all of which had been accrued as of June 30, 2015.

Three similar cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In 2010, the court in the British Columbia case certified it as a class action. After the British Columbia Court of Appeal dismissed the case, in 2013 the Canadian Supreme Court reversed the appellate court and reinstated part of the British Columbia case, which is now scheduled for trial in 2016. The other two cases are inactive.

### **Other Antitrust Litigation and Claims**

#### *GO Computer litigation*

In June 2005, GO Computer Inc. and co-founder Jerry Kaplan filed a complaint in California state court asserting antitrust claims under the Cartwright Act related to the business of the former GO Corporation in the early 1990s and its successor in interest, Lucent Corporation in the early 2000s. All claims prior to June 2001 have been dismissed with prejudice as barred by the statute of limitations. The case is moving forward with discovery, and a trial is set for September 2015.

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

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

### **Product-Related Litigation**

#### *U.S. cell phone litigation*

Nokia, along with other handset manufacturers and network operators, is a defendant in 19 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 have assumed responsibility for these claims as part of the NDS acquisition 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 10 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 September 2013, defendants in the consolidated cases moved to exclude plaintiffs' expert evidence of general causation on the basis of flawed scientific methodologies. In March 2014, defendants filed a separate motion to preclude plaintiffs' general causation testimony. In August 2014, the court granted in part defendants' motion to exclude plaintiffs' general causation experts. The plaintiffs filed an interlocutory appeal. In December 2014, the District of Columbia Court of Appeals agreed to hear *en banc* defendants' interlocutory appeal challenging the standard for evaluating expert scientific evidence. Trial court proceedings are stayed pending resolution of the appeal.

#### *Canadian cell phone class action*

Nokia, 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. Microsoft was served with the complaint in June 2014 and has been substituted for the Nokia defendants. The litigation is not yet active as several defendants remain to be served.

#### **Other**

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

As of June 30, 2015, we accrued aggregate legal liabilities of \$614 million in other current liabilities and \$20 million in other long-term liabilities. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately \$1.6 billion in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our consolidated financial statements for the period in which the effects become reasonably estimable.

### NOTE 19 — STOCKHOLDERS' EQUITY

#### **Shares Outstanding**

Shares of common stock outstanding were as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
Balance, beginning of year	8,239	8,328	8,381
Issued	83	86	105
Repurchased	(295)	(175)	(158)
Balance, end of year	<u>8,027</u>	<u>8,239</u>	<u>8,328</u>

#### **Share Repurchases**

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to \$40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. This share repurchase program replaced the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013. As of June 30, 2015, \$21.9 billion remained of our \$40.0 billion share repurchase program. All repurchases were made using cash resources.

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

(In millions)	Shares	Amount	Shares	Amount	Shares	Amount
<b>Year Ended June 30,</b>		<b>2015</b>		<b>2014 <sup>(a)</sup></b>		<b>2013</b>
First quarter	<b>43</b>	<b>\$ 2,000</b>	47	\$ 1,500	33	\$ 1,000
Second quarter	<b>43</b>	<b>2,000</b>	53	2,000	58	1,607
Third quarter	<b>116</b>	<b>5,000</b>	47	1,791	36	1,000
Fourth quarter	<b>93</b>	<b>4,209</b>	28	1,118	31	1,000
<b>Total</b>	<b>295</b>	<b>\$ 13,209</b>	<b>175</b>	<b>\$ 6,409</b>	<b>158</b>	<b>\$ 4,607</b>

(a) Of the 175 million shares repurchased in fiscal year 2014, 128 million shares were repurchased for \$4.9 billion under the share repurchase program approved by our Board of Directors on September 16, 2013 and 47 million shares were repurchased for \$1.5 billion under the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013.

The above table excludes shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards.

## Dividends

In fiscal year 2015, our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(In millions)	
<b>September 16, 2014</b>	<b>\$ 0.31</b>	<b>November 20, 2014</b>	<b>\$ 2,547</b>	<b>December 11, 2014</b>
<b>December 3, 2014</b>	<b>\$ 0.31</b>	<b>February 19, 2015</b>	<b>\$ 2,532</b>	<b>March 12, 2015</b>
<b>March 10, 2015</b>	<b>\$ 0.31</b>	<b>May 21, 2015</b>	<b>\$ 2,496</b>	<b>June 11, 2015</b>
<b>June 9, 2015</b>	<b>\$ 0.31</b>	<b>August 20, 2015</b>	<b>\$ 2,488</b>	<b>September 10, 2015</b>

The dividend declared on June 9, 2015 will be paid after the filing of our Form 10-K and was included in other current liabilities as of June 30, 2015.

In fiscal year 2014, our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(In millions)	
September 16, 2013	\$ 0.28	November 21, 2013	\$ 2,332	December 12, 2013
November 19, 2013	\$ 0.28	February 20, 2014	\$ 2,322	March 13, 2014
March 11, 2014	\$ 0.28	May 15, 2014	\$ 2,309	June 12, 2014
June 10, 2014	\$ 0.28	August 21, 2014	\$ 2,307	September 11, 2014

The dividend declared on June 10, 2014 was included in other current liabilities as of June 30, 2014.

## NOTE 20 — ACCUMULATED OTHER COMPREHENSIVE INCOME

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

(In millions)

Year Ended June 30,	2015	2014	2013
<b>Derivatives</b>			
Accumulated other comprehensive income balance, beginning of period	\$ 31	\$ 66	\$ 92
Unrealized gains, net of tax effects of <b>\$35</b> , \$2 and \$54	<b>1,152</b>	63	101
Reclassification adjustments for gains included in revenue	<b>(608)</b>	(104)	(195)
Tax expense included in provision for income taxes	<b>15</b>	6	68
Amounts reclassified from accumulated other comprehensive income	<b>(593)</b>	(98)	(127)
Net current period other comprehensive income (loss)	<b>559</b>	(35)	(26)
Accumulated other comprehensive income balance, end of period	<b>\$ 590</b>	\$ 31	\$ 66
<b>Investments</b>			
Accumulated other comprehensive income balance, beginning of period	\$ 3,531	\$ 1,794	\$ 1,431
Unrealized gains, net of tax effects of <b>\$59</b> , \$1,067 and \$244	<b>110</b>	2,053	453
Reclassification adjustments for gains included in other income (expense), net	<b>(728)</b>	(447)	(139)
Tax expense included in provision for income taxes	<b>256</b>	131	49
Amounts reclassified from accumulated other comprehensive income	<b>(472)</b>	(316)	(90)
Net current period other comprehensive income (loss)	<b>(362)</b>	1,737	363
Accumulated other comprehensive income balance, end of period	<b>\$ 3,169</b>	\$ 3,531	\$ 1,794
<b>Translation Adjustments and Other</b>			
Accumulated other comprehensive income (loss) balance, beginning of period	\$ 146	\$ (117)	\$ (101)
Translation adjustments and other, net of tax effects of <b>\$16</b> , \$12 and \$(8)	<b>(1,383)</b>	263	(16)
Accumulated other comprehensive income (loss) balance, end of period	<b>\$ (1,237)</b>	\$ 146	\$ (117)
Accumulated other comprehensive income, end of period	<b>\$ 2,522</b>	\$ 3,708	\$ 1,743

## NOTE 21 — EMPLOYEE STOCK AND SAVINGS PLANS

We grant stock-based compensation to directors and employees. At June 30, 2015, an aggregate of 294 million shares were authorized for future grant under our stock plans. Awards that expire or are canceled without delivery of shares generally become available for issuance under the plans. We issue new shares of Microsoft common stock to satisfy exercises and vesting of awards granted under all of our stock plans.

Stock-based compensation expense and related income tax benefits were as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
Stock-based compensation expense	\$ 2,574	\$ 2,446	\$ 2,406
Income tax benefits related to stock-based compensation	\$ 868	\$ 830	\$ 842

### **Stock Plans**

#### *Stock awards*

Stock awards (“SAs”) are grants that entitle the holder to shares of Microsoft common stock as the award vests. SAs generally vest over a four or five-year period.

### Executive incentive plan

Under the Executive Incentive Plan, the Compensation Committee awards SAs to executive officers and certain senior executives. The SAs vest ratably in August of each of the four years following the grant date.

### Activity for all stock plans

The fair value of each award was estimated on the date of grant using the following assumptions:

Year Ended June 30,	2015	2014	2013
Dividends per share (quarterly amounts)	\$ 0.28 - \$ 0.31	\$ 0.23 - \$ 0.28	\$ 0.20 - \$ 0.23
Interest rates range	1.2% - 1.9%	1.3% - 1.8%	0.6% - 1.1%

During fiscal year 2015, the following activity occurred under our stock plans:

	Shares	Weighted Average Grant-Date Fair Value
	(In millions)	
<b>Stock Awards</b>		
Nonvested balance, beginning of year	259	\$ 27.88
Granted	75	\$ 42.36
Vested	(94)	\$ 27.47
Forfeited	(24)	\$ 31.81
Nonvested balance, end of year	<u>216</u>	\$ 32.72

As of June 30, 2015, there was approximately \$4.7 billion of total unrecognized compensation costs related to stock awards. These costs are expected to be recognized over a weighted average period of 3 years.

During fiscal years 2014 and 2013, the following activity occurred under our stock plans:

(In millions, except fair values)	2014	2013
<b>Stock Awards</b>		
Awards granted <sup>(a)</sup>	103	104
Weighted average grant-date fair value	\$ 31.50	\$ 28.37

(a) Awards granted during fiscal year 2014 included four million shares in stock replacement awards related to the acquisition of NDS. The weighted average grant-date fair value was \$37.64.

Total vest-date fair value of stock awards vested was \$4.2 billion, \$3.2 billion, and \$2.8 billion, for fiscal years 2015, 2014, and 2013, respectively.

### Employee Stock Purchase Plan

We have an employee stock purchase plan (the "Plan") for all eligible employees. Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value on the last trading day of each three-month period. Employees may purchase shares having a value not exceeding 15% of their gross compensation during an offering period. Employees purchased the following shares during the periods presented:

(Shares in millions)	2015	2014	2013
Year Ended June 30,			
Shares purchased	16	18	20
Average price per share	\$ 39.87	\$ 33.60	\$ 26.81

At June 30, 2015, 157 million shares of our common stock were reserved for future issuance through the Plan.

## Savings Plan

We have a savings plan in the U.S. that qualifies under Section 401(k) of the Internal Revenue Code, and a number of savings plans in international locations. Participating U.S. employees may contribute up to 75% of their salary, but not more than statutory limits. We contribute fifty cents for each dollar of the first 6% a participant contributes in this plan, with a maximum contribution of the lesser of 3% of a participant's earnings or 3% of the IRS compensation limit for the given year. Matching contributions for all plans were \$454 million, \$420 million, and \$393 million in fiscal years 2015, 2014, and 2013, respectively, and were expensed as contributed. Matching contributions in the U.S. plan are invested proportionate to each participant's voluntary contributions in the investment options provided under the plan. Investment options in the U.S. plan include Microsoft common stock, but neither participant nor our matching contributions are required to be invested in Microsoft common stock.

### NOTE 22 — SEGMENT INFORMATION AND GEOGRAPHIC DATA

In its operation of the business, management, including our chief operating decision maker, the company's Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segment information in this note is reported on that basis. During the periods presented, we reported our financial performance based on the following segments; D&C Licensing, Computing and Gaming Hardware, Phone Hardware, D&C Other, Commercial Licensing, and Commercial Other.

On April 25, 2014, we acquired substantially all of NDS. See Note 9 – Business Combinations for additional details. NDS has been included in our consolidated results of operations since the acquisition date. We report the financial performance of the acquired business in our Phone Hardware segment. Prior to the acquisition of NDS, financial results associated with our joint strategic initiatives with Nokia were reflected in our D&C Licensing segment. The contractual relationship with Nokia related to those initiatives ended in conjunction with the acquisition.

Our reportable segments are described below.

#### *Devices and Consumer*

Our D&C segments develop, manufacture, market, and support products and services designed to entertain and connect people, increase personal productivity, help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. Our D&C segments are:

- **D&C Licensing**, comprising: Windows, including all OEM licensing ("Windows OEM") and other non-volume licensing and academic volume licensing of the Windows operating system and related software; non-volume licensing of Microsoft Office, comprising the core Office product set, for consumers ("Office Consumer"); Windows Phone operating system, including related patent licensing; and certain other patent licensing revenue.
- **Computing and Gaming Hardware**, comprising: Xbox gaming and entertainment consoles and accessories, second-party and third-party video game royalties, and Xbox Live subscriptions ("Xbox Platform"); Surface devices and accessories ("Surface"); and Microsoft PC accessories.
- **Phone Hardware**, comprising: Lumia phones and other non-Lumia phones, beginning with our acquisition of NDS.
- **D&C Other**, comprising: Resale, consisting of transactions in our Windows Store and Xbox marketplace; search advertising; display advertising; Office 365 Consumer, comprising Office 365 Home and Office 365 Personal; Studios, comprising first-party video games; Mojang; non-Microsoft products sold in our retail stores; and certain other consumer products and services not included in the categories above.

#### *Commercial*

Our Commercial segments develop, market, and support software and services designed to increase individual, team, and organizational productivity and efficiency, including simplifying everyday tasks through seamless operations across the user's hardware and software. Our Commercial segments are:

- **Commercial Licensing**, comprising: server products, including Windows Server, Microsoft SQL Server, Visual Studio, System Center, and related Client Access Licenses ("CALs"); Windows Embedded; volume licensing of the Windows operating system, excluding academic ("Windows Commercial"); Microsoft Office for business, including Office, Exchange, SharePoint, Skype for Business, and related CALs ("Office Commercial"); Microsoft Dynamics business solutions, excluding Dynamics CRM Online; and Skype.

- **Commercial Other**, comprising: Enterprise Services, including Premier Support Services and Microsoft Consulting Services; Commercial Cloud, comprising Office 365 Commercial, other Microsoft Office online offerings, Dynamics CRM Online, and Microsoft Azure; and certain other commercial products and online services not included in the categories above.

Revenue and cost of revenue are generally directly attributed to our segments. Certain revenue contracts are 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 directly charged to our hardware segments. For the remaining segments, cost of revenue is directly charged in most cases and allocated in certain cases, generally using a relative revenue methodology.

We do not allocate operating expenses to our segments. Rather, we allocate them to our two segment groups, Devices and Consumer and Commercial. Due to the integrated structure of our business, allocations of expenses are made in certain cases to incent cross-collaboration among our segment groups so that a segment group is not solely burdened by the cost of a mutually beneficial activity as we seek to deliver seamless experiences across devices, whether on-premises or in the cloud.

Operating expenses are attributed to our segment groups as follows:

- Sales and marketing expenses are primarily recorded directly to each segment group based on identified customer segment.
- Research and development expenses are primarily shared across the segment groups based on relative gross margin but are mapped directly in certain cases where the value of the expense only accrues to that segment group.
- General and administrative expenses are primarily allocated based on relative gross margin.

Certain corporate-level activity is not allocated to our segment groups, including costs of: legal, including expenses, settlements, and fines; information technology; human resources; finance; excise taxes; and impairment, integration, and restructuring expenses.

Segment revenue and gross margin were as follows during the periods presented:

(In millions)

Year Ended June 30,		2015	2014	2013
<b>Revenue</b>				
Devices and Consumer	Licensing	<b>\$ 14,969</b>	\$ 19,528	\$ 19,427
	Hardware:			
	Computing and Gaming Hardware	<b>10,183</b>	9,093	6,149
	Phone Hardware	<b>7,524</b>	1,982	0
	Total Devices and Consumer Hardware	<b>17,707</b>	11,075	6,149
	Other	<b>8,825</b>	7,014	6,431
	Total Devices and Consumer	<b>41,501</b>	37,617	32,007
Commercial	Licensing	<b>41,039</b>	42,085	39,778
	Other	<b>10,836</b>	7,546	5,661
	Total Commercial	<b>51,875</b>	49,631	45,439
Corporate and Other		<b>204</b>	(415)	403
Total revenue		<b>\$ 93,580</b>	\$ 86,833	\$ 77,849

(In millions)

Year Ended June 30,		2015	2014	2013
<b>Gross margin</b>				
Devices and Consumer	Licensing	<b>\$ 13,870</b>	\$ 17,439	\$ 16,985
	Hardware:			
	Computing and Gaming Hardware	<b>1,788</b>	892	956
	Phone Hardware	<b>701</b>	54	0
	Total Devices and Consumer Hardware	<b>2,489</b>	946	956
	Other	<b>2,022</b>	1,393	1,951
	Total Devices and Consumer	<b>18,381</b>	19,778	19,892
Commercial	Licensing	<b>37,830</b>	38,615	36,280
	Other	<b>4,199</b>	1,855	922
	Total Commercial	<b>42,029</b>	40,470	37,202
Corporate and Other		<b>132</b>	(493)	370
	Total gross margin	<b>\$ 60,542</b>	\$ 59,755	\$ 57,464

Below are operating expenses by segment group. As discussed above, we do not allocate operating expenses to our segments.

(In millions)

Year Ended June 30,		2015	2014	2013
Devices and Consumer		<b>\$ 11,505</b>	\$ 11,219	\$ 10,625
Commercial		<b>17,177</b>	16,993	16,050
Corporate and Other		<b>3,688</b>	3,657	4,025
	Total segment operating expenses	<b>32,370</b>	31,869	30,700
	Impairment, integration, and restructuring	<b>10,011</b>	127	0
	Total operating expenses	<b>\$ 42,381</b>	\$ 31,996	\$ 30,700

Below is operating income (loss) by segment group.

(In millions)

Year Ended June 30,		2015	2014	2013
Devices and Consumer		<b>\$ 6,876</b>	\$ 8,559	\$ 9,267
Commercial		<b>24,852</b>	23,477	21,152
Corporate and Other		<b>(13,567)</b>	(4,277)	(3,655)
	Total operating income	<b>\$ 18,161</b>	\$ 27,759	\$ 26,764

Corporate and Other operating income includes adjustments to conform our internal accounting policies to U.S. GAAP, corporate-level activity not specifically attributed to a segment, and impairment, integration, and restructuring expenses. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, and depreciation.

Corporate and Other activity was as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
Corporate <sup>(a) (b)</sup>	\$ (13,575)	\$ (3,744)	\$ (4,102)
Other (adjustments to U.S. GAAP):			
Revenue reconciling amounts <sup>(c)</sup>	204	(415)	403
Cost of revenue reconciling amounts	(72)	(78)	(31)
Operating expenses reconciling amounts	(124)	(40)	75
Total Corporate and Other	<u>\$ (13,567)</u>	<u>\$ (4,277)</u>	<u>\$ (3,655)</u>

- (a) Corporate is presented on the basis of our internal accounting policies and excludes the adjustments to U.S. GAAP that are presented separately in those line items.
- (b) Corporate for fiscal year 2015 included impairment, integration, and restructuring expenses of \$10.0 billion.
- (c) Revenue reconciling amounts for fiscal year 2015 included a net \$303 million of previously deferred net revenue related to sales of bundled products and services ("Bundled Offerings"). Revenue reconciling amounts for fiscal year 2014 included a net \$349 million of revenue deferrals related to Bundled Offerings. Revenue reconciling amounts for fiscal year 2013 included the recognition of \$540 million of revenue previously deferred on sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price.

No sales to an individual customer or country other than the United States accounted for more than 10% of fiscal year 2015, 2014, or 2013 revenue. Revenue, classified by the major geographic areas in which our customers are located, was as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
United States <sup>(a)</sup>	\$ 42,941	\$ 43,474	\$ 41,344
Other countries	50,639	43,359	36,505
Total	<u>\$ 93,580</u>	<u>\$ 86,833</u>	<u>\$ 77,849</u>

- (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 were as follows:

(In millions)

Year Ended June 30,	2015	2014	2013
Microsoft Office system	\$ 23,538	\$ 24,323	\$ 22,995
Server products and tools	18,612	17,055	15,408
Windows PC operating system	14,826	16,856	17,529
Xbox	9,121	8,643	7,100
Phone	7,702	3,073	615
Consulting and product support services	5,090	4,767	4,372
Advertising	4,557	4,016	3,387
Surface	3,900	1,883	853
Other	6,234	6,217	5,590
Total	<u>\$ 93,580</u>	<u>\$ 86,833</u>	<u>\$ 77,849</u>

Our total Commercial Cloud revenue was \$5.8 billion, \$2.8 billion, and \$1.3 billion in fiscal years 2015, 2014, and 2013, respectively. These amounts are included in their respective product categories in the table above.

Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is charged to the respective 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.

Long-lived assets, excluding financial instruments and tax assets, classified by the location of the controlling statutory company and with countries over 10% of the total shown separately, were as follows:

(In millions)

June 30,	2015	2014	2013
United States	\$19,562	\$17,653	\$16,615
Luxembourg	6,879	6,913	6,943
Finland	1,757	9,840	12
Other countries	8,307	5,713	4,159
Total	<u>\$36,505</u>	<u>\$40,119</u>	<u>\$27,729</u>

#### NOTE 23 — QUARTERLY INFORMATION (UNAUDITED)

(In millions, except per share amounts)

Quarter Ended	September 30	December 31	March 31	June 30	Total
<b>Fiscal Year 2015</b>					
Revenue	\$ 23,201	\$ 26,470	\$ 21,729	\$ 22,180	\$ 93,580
Gross margin	14,928	16,334	14,568	14,712	60,542
Net income (loss)	4,540	5,863	4,985	(3,195) <sup>(a)</sup>	12,193 <sup>(b)</sup>
Basic earnings (loss) per share	0.55	0.71	0.61	(0.40)	1.49
Diluted earnings (loss) per share	0.54	0.71	0.61	(0.40) <sup>(a)</sup>	1.48 <sup>(b)</sup>
<b>Fiscal Year 2014</b>					
Revenue	\$ 18,529	\$ 24,519	\$ 20,403	\$ 23,382	\$ 86,833
Gross margin	13,384	16,197	14,425	15,749	59,755
Net income	5,244	6,558	5,660	4,612 <sup>(c)</sup>	22,074 <sup>(c)</sup>
Basic earnings per share	0.63	0.79	0.68	0.56	2.66
Diluted earnings per share	0.62	0.78	0.68	0.55 <sup>(c)</sup>	2.63 <sup>(c)</sup>

(a) Includes \$7.5 billion of goodwill and asset impairment charges related to Phone Hardware, as well as \$940 million of integration and restructuring expenses, primarily costs associated with our Phone Hardware Restructuring Plan, which decreased fourth quarter fiscal year 2015 net income by \$8.4 billion and diluted EPS by \$1.02.

(b) Includes \$7.5 billion of goodwill and asset impairment charges related to Phone Hardware, as well as \$2.5 billion of integration and restructuring expenses, primarily costs associated with our restructuring plans, which decreased fiscal year 2015 net income by \$10.0 billion and diluted EPS by \$1.15.

(c) Includes a tax provision adjustment recorded in the fourth quarter of fiscal year 2014 related to adjustments to prior years' liabilities for intercompany transfer pricing which decreased net income by \$458 million and diluted EPS by \$0.05.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2015 and 2014, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders' equity for each of the three years in the period ended June 30, 2015. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2015, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of June 30, 2015, based on the criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated July 31, 2015, expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington

July 31, 2015

## **CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

### **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.

### **REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the company. Internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of our financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes maintaining records that in reasonable detail accurately and fairly reflect our transactions; providing reasonable assurance that transactions are recorded as necessary for preparation of our financial statements; providing reasonable assurance that receipts and expenditures of company assets are made in accordance with management authorization; and providing reasonable assurance that unauthorized acquisition, use or disposition of company assets that could have a material effect on our financial statements would be prevented or detected on a timely basis. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected.

Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of June 30, 2015. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Deloitte & Touche LLP has audited our internal control over financial reporting as of June 30, 2015; their report follows.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the internal control over financial reporting of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2015, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2015, based on the criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended June 30, 2015, of the Company and our report dated July 31, 2015, expressed an unqualified opinion on those financial statements.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington  
July 31, 2015

# DIRECTORS AND EXECUTIVE OFFICERS OF MICROSOFT CORPORATION

## DIRECTORS

**John W. Thompson** <sup>3,4</sup>  
Independent Chairman,  
Microsoft Corporation; Chief Executive  
Officer, Virtual Instruments, Inc.

**William H. Gates III**  
Co-Chair and Trustee,  
Bill & Melinda Gates Foundation

**Maria M. Klawe** <sup>2,4</sup>  
President,  
Harvey Mudd College

**Teri L. List-Stoll** <sup>1,3</sup>  
Executive Vice President and Chief  
Financial Officer,  
DICK'S Sporting Goods, Inc

**G. Mason Morfit** <sup>1,2</sup>  
President,  
ValueAct Capital

**Satya Nadella**  
Chief Executive Officer,  
Microsoft Corporation

**Charles H. Noski** <sup>1,3</sup>  
Former Vice Chairman,  
Bank of America Corporation

**Helmut G. W. Panke** <sup>1,2,4</sup>  
Former Chairman of the Board  
of Management, BMW AG

**Charles W. Scharf** <sup>3</sup>  
Chief Executive Officer, Visa, Inc.

**John W. Stanton** <sup>2,4</sup>  
Chairman, Trilogy International  
Partners, Inc.

### Board Committees

1. Audit Committee
2. Compensation Committee
3. Governance and Nominating Committee
4. Regulatory and Public Policy Committee

## EXECUTIVE OFFICERS

**Satya Nadella**  
Chief Executive Officer

**Christopher C. Capossela**  
Executive Vice President, Chief  
Marketing Officer

**Kathleen T. Hogan**  
Executive Vice President, Human  
Resources

**Amy E. Hood**  
Executive Vice President, Chief  
Financial Officer

**Margaret (Peggy) L. Johnson**  
Executive Vice President, Business  
Development

**Bradford L. Smith**  
President, Chief Legal Officer

**B. Kevin Turner**  
Chief Operating Officer

## INVESTOR RELATIONS

### Investor Relations

**You can contact Microsoft Investor Relations at any time to order financial documents such as annual reports and Form 10-Ks free of charge.**

Call us toll-free at (800) 285-7772 or outside the United States, call (425) 706-4400. We can be contacted between the hours of 9:00 a.m. to 5:00 p.m. Pacific Time to answer investment oriented questions about Microsoft.

For access to additional financial information, visit the Investor Relations website online at:  
[www.microsoft.com/investor](http://www.microsoft.com/investor)

Our e-mail is [msft@microsoft.com](mailto:msft@microsoft.com)

Our mailing address is:  
Investor Relations  
Microsoft Corporation  
One Microsoft Way  
Redmond, Washington 98052-6399

### Annual Meeting

8:00 a.m. Pacific Time December 2, 2015  
Meydenbauer Center  
11100 NE 6<sup>th</sup> Street  
Bellevue, Washington 98004

### **Proof of Ownership Required**

You are entitled to attend the Annual Meeting only if you are a shareholder as of the close of business on October 2, 2015, the record date, or hold a valid proxy for the meeting. In order to be admitted to the Annual Meeting, you must present proof of ownership of Microsoft stock on the record date.

- The Notice of Internet Availability of Proxy Materials
- A proxy card
- Legal proxy provided by your bank, broker, or nominee
- Voting instruction card
- If you received your proxy materials by email, a printout of the email
- Brokerage statement or letter from a bank or broker indicating ownership on October 2, 2015

Any holder of a proxy from a shareholder must present the proxy card, properly executed, and a copy of the proof of ownership. Shareholders and proxy holders must also present a form of photo identification such as a driver's license or passport. We reserve the right to deny entry to any person who does not present identification or refuses to comply with our security procedures.

### Registered Shareholder Services

American Stock Transfer & Trust Company (AST), our transfer agent, can help you with a variety of shareholder related services including:

- Change of address
- Lost stock certificates
- Transfer of stock to another person
- Additional administrative services

AST also administers a direct stock purchase plan and a dividend reinvestment program for the company.

To find out more about these services and programs you may contact AST directly at 800-285-7772, option 1 between the hours of 5:00 a.m. and 5:00 p.m. Pacific Time, Monday through Fridays, or visit AST online at:  
<http://www.amstock.com>

You can e-mail the transfer agent at:  
[msft@amstock.com](mailto:msft@amstock.com)

You can also send mail to the transfer agent at:  
Microsoft Corporation  
c/o American Stock Transfer & Trust Company  
P.O. Box 2362  
New York, NY 10272-2362

Shareholders can sign up for electronic alerts to access the annual report and proxy statement online. The service gets you the information you need faster and also gives you the power and convenience of online proxy voting. To sign up for this free service, visit the Annual Report site on the Investor Relations website at:  
<http://www.microsoft.com/investor/AnnualReports/default.aspx>

### Corporate Citizenship

Microsoft's citizenship mission is to serve globally the needs of communities and fulfill our responsibilities to the public. With our citizenship commitments, we seek to advance our company mission to empower every person and every organization on the planet to achieve more through our corporate policies and business practices, our products, and our investments in communities. We appreciate the inquiries we receive from many investors about our citizenship work, which contributes long-term value to our business, our shareholders, and communities around the world. When individuals and societies thrive, so do we. That's a guiding philosophy behind Microsoft YouthSpark, a three-year commitment we surpassed this year to create opportunities for 300 million youth through technology, training and experiences. It's also why we seek to do business in principled ways that respect people and the planet.

For more about Microsoft's corporate citizenship commitments and performance, please visit:  
<http://www.microsoft.com/citizenship>.

