MICROSOFT CORP
Form 10-Q
April 28, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended March 31, 2011

OR

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

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

(425) 882-8080

(Registrant s telephone number, including area code)

None

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

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

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

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

Large accelerated filer x

Accelerated filer ¨

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

Smaller reporting company ¨

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

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

Class	**Outstanding at April 21, 2011**
Common Stock, $0.00000625 par value per share	8,432,767,307 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended March 31, 2011

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Item 1

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Revenue	**$ 16,428**	$ 14,503	**$ 52,576**	$ 46,445
Operating expenses:				
Cost of revenue	**3,897**	2,755	**11,869**	9,225
Research and development	**2,269**	2,220	**6,650**	6,364
Sales and marketing	**3,393**	3,203	**10,024**	9,612
General and administrative	**1,160**	1,152	**3,043**	3,076
Total operating expenses	**10,719**	9,330	**31,586**	28,277
Operating income	**5,709**	5,173	**20,990**	18,168
Other income	**316**	168	**762**	821
Income before income taxes	**6,025**	5,341	**21,752**	18,989
Provision for income taxes	**793**	1,335	**4,476**	4,747
Net income	**$ 5,232**	$ 4,006	**$ 17,276**	$ 14,242
Earnings per share:				
Basic	**$ 0.62**	$ 0.46	**$ 2.03**	$ 1.61
Diluted	**$ 0.61**	$ 0.45	**$ 2.01**	$ 1.59
Weighted average shares outstanding:				
Basic	**8,420**	8,767	**8,511**	8,846
Diluted	**8,510**	8,876	**8,609**	8,955
Cash dividends declared per common share	**$ 0.16**	$ 0.13	**$ 0.48**	$ 0.39

See accompanying notes.

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BALANCE SHEETS

(In millions)

	March 31, 2011 (Unaudited)	June 30, 2010[1]
Assets		
Current assets:		
Cash and cash equivalents	**$ 7,021**	$ 5,505
Short-term investments (including securities loaned of **$1,171** and $62)	**43,129**	31,283
Total cash, cash equivalents, and short-term investments	**50,150**	36,788
Accounts receivable, net of allowance for doubtful accounts of **$304** and $375	**10,033**	13,014
Inventories	**1,056**	740
Deferred income taxes	**2,586**	2,184
Other	**2,438**	2,950
Total current assets	**66,263**	55,676
Property and equipment, net of accumulated depreciation of **$9,564** and $8,629	**7,969**	7,630
Equity and other investments	**10,748**	7,754
Goodwill	**12,554**	12,394
Intangible assets, net	**840**	1,158
Other long-term assets	**1,353**	1,501
Total assets	**$ 99,727**	$ 86,113
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,829**	$ 4,025
Short-term debt	**0**	1,000
Accrued compensation	**2,917**	3,283
Income taxes	**839**	1,074
Short-term unearned revenue	**11,887**	13,652
Securities lending payable	**1,245**	182
Other	**3,325**	2,931
Total current liabilities	**24,042**	26,147
Long-term debt	**11,915**	4,939
Long-term unearned revenue	**1,132**	1,178
Deferred income taxes	**1,185**	229
Other long-term liabilities	**8,001**	7,445
Total liabilities	**46,275**	39,938
Commitments and contingencies		
Stockholders equity:		

Common stock and paid-in capital shares authorized 24,000; outstanding **8,431** and 8,668	**63,234**	62,856
Retained deficit, including accumulated other comprehensive income of **$1,810** and $1,055	**(9,782)**	(16,681)
Total stockholders equity	**53,452**	46,175
Total liabilities and stockholders equity	**$ 99,727**	$ 86,113

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

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended March 31, 2011	2010	Nine Months Ended March 31, 2011	2010
Operations				
Net income	**$ 5,232**	$ 4,006	**$ 17,276**	$ 14,242
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	**720**	694	**2,077**	1,955
Stock-based compensation expense	**541**	481	**1,622**	1,409
Net recognized gains on investments and derivatives	**(122)**	(68)	**(377)**	(322)
Excess tax benefits from stock-based compensation	**(5)**	(14)	**(14)**	(38)
Deferred income taxes	**(59)**	(241)	**(324)**	263
Deferral of unearned revenue	**6,616**	6,087	**19,331**	19,692
Recognition of unearned revenue	**(7,026)**	(6,395)	**(21,189)**	(21,758)
Changes in operating assets and liabilities:				
Accounts receivable	**3,031**	1,947	**3,435**	1,906
Inventories	**(170)**	77	**(258)**	216
Other current assets	**(618)**	(361)	**(487)**	90
Other long-term assets	**(8)**	(81)	**172**	(143)
Accounts payable	**(51)**	122	**(235)**	89
Other current liabilities	**237**	775	**(1,174)**	(146)
Other long-term liabilities	**354**	364	**1,197**	1,014
Net cash from operations	**8,672**	7,393	**21,052**	18,469
Financing				
Short-term debt repayments, maturities of 90 days or less, net	**0**	(349)	**(186)**	(446)
Proceeds from issuance of debt, maturities longer than 90 days	**2,239**	851	**6,960**	2,592
Repayments of debt, maturities longer than 90 days	**0**	(502)	**(814)**	(1,898)
Common stock issued	**1,405**	422	**2,242**	1,399
Common stock repurchased	**(848)**	(2,023)	**(10,299)**	(7,430)
Common stock cash dividends paid	**(1,349)**	(1,139)	**(3,830)**	(3,448)
Excess tax benefits from stock-based compensation	**5**	14	**14**	38
Other	**(15)**	0	**(40)**	0
Net cash from (used in) financing	**1,437**	(2,726)	**(5,953)**	(9,193)
Investing				
Additions to property and equipment	**(658)**	(408)	**(1,713)**	(1,219)
Acquisition of companies, net of cash acquired	**0**	(143)	**(69)**	(245)
Purchases of investments	**(14,394)**	(11,217)	**(27,707)**	(25,994)
Maturities of investments	**2,286**	1,054	**4,992**	6,448
Sales of investments	**5,738**	4,927	**9,768**	12,705
Securities lending payable	**(111)**	(117)	**1,063**	1,110

Net cash used in investing	**(7,139)**	(5,904)	**(13,666)**	(7,195)
Effect of exchange rates on cash and cash equivalents	**28**	(30)	**83**	(2)
Net change in cash and cash equivalents	**2,998**	(1,267)	**1,516**	2,079
Cash and cash equivalents, beginning of period	**4,023**	9,422	**5,505**	6,076
Cash and cash equivalents, end of period	**$ 7,021**	$ 8,155	**$ 7,021**	$ 8,155

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Common stock and paid-in capital				
Balance, beginning of period	**$ 61,646**	$ 62,566	**$ 62,856**	$ 62,382
Common stock issued	**1,405**	372	**2,242**	1,399
Common stock repurchased	**(240)**	(495)	**(3,220)**	(2,151)
Stock-based compensation	**541**	481	**1,622**	1,409
Stock-based compensation income tax deficiencies	**(118)**	(407)	**(266)**	(522)
Balance, end of period	**63,234**	62,517	**63,234**	62,517
Retained deficit				
Balance, beginning of period	**(13,165)**	(18,283)	**(16,681)**	(22,824)
Net income	**5,232**	4,006	**17,276**	14,242
Other comprehensive income:				
Net unrealized gains (losses) on derivatives	**(70)**	103	**(656)**	(258)
Net unrealized gains on investments	**83**	124	**1,099**	777
Translation adjustments and other	**99**	(97)	**311**	(36)
Comprehensive income	**5,344**	4,136	**18,030**	14,725
Common stock cash dividends	**(1,353)**	(1,132)	**(4,052)**	(3,429)
Common stock repurchased	**(608)**	(1,528)	**(7,079)**	(5,279)
Balance, end of period	**(9,782)**	(16,807)	**(9,782)**	(16,807)
Total stockholders equity	**$ 53,452**	$ 45,710	**$ 53,452**	$ 45,710

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Accounting Principles

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2010 Form 10-K filed on July 30, 2010 with the U.S. Securities and Exchange Commission.

Principles of Consolidation

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

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

Recently Adopted Accounting Guidance

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

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

Recent Accounting Guidance Not Yet Adopted

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

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NOTE 2 EARNINGS PER SHARE

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

(In millions, except earnings per share)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Net income available for common shareholders (A)	**$ 5,232**	$ 4,006	**$ 17,276**	$ 14,242
Weighted average shares of common stock (B)	**8,420**	8,767	**8,511**	8,846
Dilutive effect of stock-based awards	**90**	109	**98**	109
Common stock and common stock equivalents (C)	**8,510**	8,876	**8,609**	8,955
Earnings per share:				
Basic (A/B)	**$ 0.62**	$ 0.46	**$ 2.03**	$ 1.61
Diluted (A/C)	**$ 0.61**	$ 0.45	**$ 2.01**	$ 1.59

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

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Shares excluded from calculations of diluted EPS	**18**	41	**22**	49

The decrease in anti-dilutive shares is due mainly to the decrease in employee stock options outstanding.

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

NOTE 3 OTHER INCOME

The components of other income were as follows:

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	**2011**	2010
Dividends and interest income	**$ 216**	$ 204	**$ 631**	$ 604
Interest expense	**(84)**	(38)	**(201)**	(114)
Net recognized gains on investments	**187**	137	**339**	299
Net gains (losses) on derivatives	**(65)**	(69)	**38**	23
Net gains (losses) on foreign currency remeasurements	**55**	(56)	**(14)**	(24)
Other	**7**	(10)	**(31)**	33
Total	**$ 316**	$ 168	**$ 762**	$ 821

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NOTE 4 INVESTMENTS

Investment Components

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

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
March 31, 2011							
Cash	**$ 1,829**	**$ 0**	**$ 0**	**$ 1,829**	**$ 1,829**	**$ 0**	**$ 0**
Mutual funds	**1,649**	**0**	**0**	**1,649**	**1,649**	**0**	**0**
Certificates of deposit	**1,248**	**0**	**0**	**1,248**	**970**	**278**	**0**
U.S. government and agency securities	**32,625**	**123**	**(7)**	**32,741**	**874**	**31,867**	**0**
Foreign government bonds	**547**	**9**	**(1)**	**555**	**0**	**555**	**0**
Mortgage-backed securities	**2,417**	**103**	**(4)**	**2,516**	**0**	**2,516**	**0**
Corporate notes and bonds	**8,926**	**245**	**(13)**	**9,158**	**1,699**	**7,459**	**0**
Municipal securities	**441**	**3**	**(5)**	**439**	**0**	**439**	**0**
Common and preferred stock	**7,666**	**2,573**	**(125)**	**10,114**	**0**	**0**	**10,114**
Other investments	**649**	**0**	**0**	**649**	**0**	**15**	**634**
Total	**$ 57,997**	**$ 3,056**	**$ (155)**	**$ 60,898**	**$ 7,021**	**$ 43,129**	**$ 10,748**

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2010							
Cash	$ 1,661	$ 0	$ 0	$ 1,661	$ 1,661	$ 0	$ 0
Mutual funds	1,120	0	0	1,120	1,120	0	0
Commercial paper	188	0	0	188	13	175	0
Certificates of deposit	348	0	0	348	68	280	0
U.S. government and agency securities	21,036	167	(1)	21,202	1,822	19,380	0
Foreign government bonds	518	13	0	531	0	531	0
Mortgage-backed securities	3,137	135	(7)	3,265	0	3,265	0
Corporate notes and bonds	7,450	289	(18)	7,721	701	7,020	0
Municipal securities	726	22	(1)	747	120	627	0
Common and preferred stock	6,640	1,030	(418)	7,252	0	0	7,252
Other investments	507	0	0	507	0	5	502

Total	$ 43,331	$ 1,656	$ (445)	$ 44,542	$ 5,505	$ 31,283	$ 7,754

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Unrealized Losses on Investments

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

	Less than 12 Months		12 Months or Greater			Total
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
March 31, 2011						
U.S. government and agency securities	**$ 286**	**$ (7)**	**$ 0**	**$ 0**	**$ 286**	**$ (7)**
Foreign government bonds	**293**	**(1)**	**0**	**0**	**293**	**(1)**
Mortgage-backed securities	**75**	**(3)**	**15**	**(1)**	**90**	**(4)**
Corporate notes and bonds	**496**	**(12)**	**25**	**(1)**	**521**	**(13)**
Municipal securities	**174**	**(5)**	**0**	**0**	**174**	**(5)**
Common and preferred stock	**945**	**(99)**	**160**	**(26)**	**1,105**	**(125)**
Total	**$ 2,269**	**$ (127)**	**$ 200**	**$ (28)**	**$ 2,469**	**$ (155)**

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

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 March 31, 2011.

At March 31, 2011 and June 30, 2010, the recorded bases and estimated fair values of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $319 million and $216 million, respectively.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
March 31, 2011		
Due in one year or less	$ 21,223	$ 21,294
Due after one year through five years	19,550	19,723
Due after five years through 10 years	2,450	2,556
Due after 10 years	2,981	3,084
Total	$ 46,204	$ 46,657

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NOTE 5 DERIVATIVES

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

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

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. As of March 31, 2011 and June 30, 2010, the total notional amounts of these foreign exchange contracts sold were $10.9 billion and $9.3 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of March 31, 2011 and June 30, 2010, the total notional amounts of these foreign exchange contracts sold were $536 million and $523 million, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of March 31, 2011, the total notional amounts of these foreign exchange contracts purchased and sold were $5.8 billion and $4.6 billion, respectively. As of June 30, 2010, the total notional amounts of these foreign exchange contracts purchased and sold were $7.8 billion and $5.3 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of March 31, 2011, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.7 billion and $1.4 billion, respectively. As of June 30, 2010, the total notional amounts of designated and non-designated equity contracts purchased and sold were $918 million and $472 million, respectively.

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of March 31, 2011, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.4 billion and $1.4 billion, respectively. As of June 30, 2010, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.1 billion and $1.8 billion, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of March 31, 2011 and June 30, 2010, the total notional derivative amount of mortgage contracts purchased were $828 million and $305 million, respectively.

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low cost method of managing exposure to individual credit risks or groups of credit risks. As of March 31, 2011 and June 30, 2010, the total notional amounts of credit contracts purchased and sold were immaterial.

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Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swap, futures, and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of March 31, 2011, the total notional amounts of commodity contracts purchased and sold were $1.5 billion and $520 million, respectively. As of June 30, 2010, the total notional amounts of commodity contracts purchased and sold were $1.1 billion and $376 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain a minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of March 31, 2011, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral was required to be posted.

Fair Values of Derivative Instruments

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

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

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

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

Following are the gross fair values of derivative instruments designated as hedging instruments (designated hedge derivatives) and not designated as hedging instruments (non-designated hedge derivatives) that were held at March 31, 2011 and June 30, 2010. 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.

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(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
March 31, 2011						
Assets						
Non-designated hedge derivatives:						
Short-term investments	**$ 20**	**$ 197**	**$ 19**	**$ 15**	**$ 30**	**$ 281**
Other current assets	**76**	**0**	**0**	**0**	**0**	**76**
Total	**$ 96**	**$ 197**	**$ 19**	**$ 15**	**$ 30**	**$ 357**
Designated hedge derivatives:						
Short-term investments	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 0**
Other current assets	**104**	**0**	**0**	**0**	**0**	**104**
Total	**$ 104**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 104**
Total assets	**$ 200**	**$ 197**	**$ 19**	**$ 15**	**$ 30**	**$ 461**
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	**$ (74)**	**$ (12)**	**$ (5)**	**$ (14)**	**$ (26)**	**$ (131)**
Designated hedge derivatives:						
Other current liabilities	**$ (229)**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ (229)**
Total liabilities	**$ (303)**	**$ (12)**	**$ (5)**	**$ (14)**	**$ (26)**	**$ (360)**

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
June 30, 2010						
Assets						
Non-designated hedge derivatives:						
Short-term investments	$ 15	$ 134	$ 12	$ 7	$ 8	$ 176
Other current assets	34	0	0	0	0	34
Total	$ 49	$ 134	$ 12	$ 7	$ 8	$ 210
Designated hedge derivatives:						
Short-term investments	$ 3	$ 0	$ 0	$ 0	$ 0	$ 3
Other current assets	563	0	0	0	0	563

Total	$ 566	$ 0	$ 0	$ 0	$ 0	$ 566
Total assets	$ 615	$ 134	$ 12	$ 7	$ 8	$ 776
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	$ (60)	$ (17)	$ (33)	$ (41)	$ (5)	$ (156)
Designated hedge derivatives:						
Other current liabilities	$ (9)	$ 0	$ 0	$ 0	$ 0	$ (9)
Total liabilities	$ (69)	$ (17)	$ (33)	$ (41)	$ (5)	$ (165)

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

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Fair Value Hedges

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

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Derivatives	**$ (28)**	$ (2)	**$ (78)**	$ (106)
Hedged items	**26**	4	**74**	107
Total	**$ (2)**	$ 2	**$ (4)**	$ 1

Cash Flow Hedges

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

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Effective portion				
Gain (loss) recognized in OCI, net of tax effect of **$(48)** for the three months ended and **$(315)** for the nine months ended March 31, 2011, and $85 for the three months and $(26) for the nine months ended March 31, 2010	**$ (90)**	$ 159	**$ (587)**	$ (48)
Gain (loss) reclassified from OCI into revenue	**(30)**	85	**109**	322
Amount excluded from effectiveness assessment and ineffective portion				
Loss recognized in other income	**(123)**	(62)	**(226)**	(76)

We estimate that $214 million of net derivative losses included in OCI will be reclassified into earnings within the next 12 months. No significant amounts of gains (losses) were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the three months and nine months ended March 31, 2011 and 2010.

Non-Designated Derivatives

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). These amounts are shown in the table below, with the exception of gains (losses) on derivatives presented in income statement line items other than other income (expense), which were immaterial for the three months and nine months ended March 31, 2011 and 2010. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities.

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Foreign exchange contracts	**$ 51**	$ 1	**$ (34)**	$ 91
Equity contracts	**8**	8	**39**	24
Interest-rate contracts	**8**	8	**20**	20
Credit contracts	**(3)**	7	**25**	18
Commodity contracts	**48**	(35)	**206**	34
Total	**$ 112**	$ (11)	**$ 256**	$ 187

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NOTE 6   FAIR VALUE MEASUREMENTS

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

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

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

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

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

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Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[(a)]	Net Fair Value
March 31, 2011						
Assets						
Mutual funds	**$ 1,649**	**$ 0**	**$ 0**	**$ 1,649**	**$ 0**	**$ 1,649**
Certificates of deposit	**0**	**1,248**	**0**	**1,248**	**0**	**1,248**
U.S. government and agency securities	**24,834**	**7,907**	**0**	**32,741**	**0**	**32,741**
Foreign government bonds	**127**	**440**	**0**	**567**	**0**	**567**
Mortgage-backed securities	**0**	**2,515**	**0**	**2,515**	**0**	**2,515**
Corporate notes and bonds	**0**	**8,898**	**65**	**8,963**	**0**	**8,963**
Municipal securities	**0**	**439**	**0**	**439**	**0**	**439**
Common and preferred stock	**9,737**	**51**	**5**	**9,793**	**0**	**9,793**
Derivatives	**29**	**418**	**14**	**461**	**(232)**	**229**
Total	**$ 36,376**	**$ 21,916**	**$ 84**	**$ 58,376**	**$ (232)**	**$ 58,144**
Liabilities						
Derivatives and other	**$ 124**	**$ 342**	**$ 0**	**$ 466**	**$ (232)**	**$ 234**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[(a)]	Net Fair Value
June 30, 2010						
Assets						
Mutual funds	$ 1,120	$ 0	$ 0	$ 1,120	$ 0	$ 1,120
Commercial paper	0	172	0	172	0	172
Certificates of deposit	0	348	0	348	0	348
U.S. government and agency securities	16,473	4,756	0	21,229	0	21,229
Foreign government bonds	239	294	0	533	0	533
Mortgage-backed securities	0	3,264	0	3,264	0	3,264
Corporate notes and bonds	0	7,460	167	7,627	0	7,627
Municipal securities	0	747	0	747	0	747
Common and preferred stock	6,988	43	5	7,036	0	7,036
Derivatives	22	745	9	776	(207)	569
Total	$ 24,842	$ 17,829	$ 181	$ 42,852	$ (207)	$ 42,645

Liabilities						
Derivatives and other	$ 85	$ 137	$ 0	$ 222	$ (205)	$ 17

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

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The table below reconciles the total Net Fair Value of assets above to the balance sheet presentation of these same assets in Note 4 Investments for March 31, 2011 and June 30, 2010.

(In millions)	March 31, 2011	June 30, 2010
Net fair value of assets measured at fair value on a recurring basis	**$ 58,144**	$ 42,645
Cash	**1,829**	1,661
Common and preferred stock measured at fair value on a nonrecurring basis	**319**	216
Other investments measured at fair value on a nonrecurring basis	**634**	502
Less derivative assets classified as other current assets	**(29)**	(544)
Other	**1**	62
Recorded basis of investment components	**$ 60,898**	$ 44,542

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

The following tables present the changes during the three months and nine months ended March 31, 2011 and 2010 in our Level 3 financial instruments that are measured at fair value on a recurring basis. The majority of these instruments consist of investment securities classified as available-for-sale with changes in fair value included in OCI.

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three Months and Nine Months Ended March 31, 2011				
Balance as of June 30, 2010	**$ 167**	**$ 5**	**$ 9**	**$ 181**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**2**	**0**	**7**	**9**
Included in other comprehensive income	**(2)**	**0**	**0**	**(2)**
Balance as of September 30, 2010	**$ 167**	**$ 5**	**$ 16**	**$ 188**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**2**	**0**	**(1)**	**1**
Included in other comprehensive income	**2**	**0**	**0**	**2**
Balance as of December 31, 2010	**$ 171**	**$ 5**	**$ 15**	**$ 191**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**34**	**0**	**(1)**	**33**
Included in other comprehensive income	**(55)**	**0**	**0**	**(55)**
Purchases, issuances and settlements	**(85)**	**0**	**0**	**(85)**

Balance as of March 31, 2011	**$ 65**	**$ 5**	**$ 14**	**$ 84**
Change in unrealized gains (losses) included in other income (expense) for the three months ended March 31, 2011 related to assets held as of March 31, 2011	**$ 1**	**$ 0**	**$ (1)**	**$ 0**
Change in unrealized gains (losses) included in other income (expense) for the nine months ended March 31, 2011 related to assets held as of March 31, 2011	**$ 5**	**$ 0**	**$ 5**	**$ 10**

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(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three Months and Nine Months Ended March 31, 2010				
Balance as of June 30, 2009	$ 253	$ 5	$ 5	$ 263
Total realized and unrealized gains (losses):				
Included in other income (expense)	1	0	(2)	(1)
Included in other comprehensive income	(74)	0	0	(74)
Balance as of September 30, 2009	$ 180	$ 5	$ 3	$ 188
Total realized and unrealized gains:				
Included in other income (expense)	1	0	1	2
Included in other comprehensive income	11	0	0	11
Balance as of December 31, 2009	$ 192	$ 5	$ 4	$ 201
Total realized and unrealized gains:				
Included in other income (expense)	2	0	2	4
Included in other comprehensive income	0	0	0	0
Balance as of March 31, 2010	$ 194	$ 5	$ 6	$ 205
Change in unrealized gains (losses) included in other income (expense) for the three months ended March 31, 2010 related to assets held as of March 31, 2010	$ 2	$ 0	$ 2	$ 4
Change in unrealized gains (losses) included in other income (expense) for the nine months ended March 31, 2010 related to assets held as of March 31, 2010	$ 4	$ 0	$ 1	$ 5

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

During the three months and nine months ended March 31, 2011 and 2010, we did not record any other-than-temporary impairments on those assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)	March 31, 2011	June 30, 2010
Raw materials	**$ 175**	$ 172
Work in process	**54**	16
Finished goods	**827**	552

Total	**$ 1,056**	$ 740

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NOTE 8 GOODWILL

Changes in our goodwill balances during the three months and nine months ended March 31, 2011 were as follows:

(In millions)	Balance December 31, 2010	Acquisitions	Purchase Accounting Adjustments and Other	Balance March 31, 2011
Windows & Windows Live Division	$ 89	$ 0	$ 0	$ 89
Server and Tools	1,138	0	1	1,139
Online Services Division	6,373	0	0	6,373
Microsoft Business Division	4,091	0	49	4,140
Entertainment and Devices Division	811	0	2	813
Total	$ 12,502	$ 0	$ 52	$ 12,554

(In millions)	Balance June 30, 2010	Acquisitions	Purchase Accounting Adjustments and Other	Balance March 31, 2011
Windows & Windows Live Division	$ 77	$ 0	$ 12	$ 89