MICROSOFT CORP
Form 10-Q
October 18, 2012
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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 September 30, 2012

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 October 15, 2012**
Common Stock, $0.00000625 par value per share	8,416,462,491 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended September 30, 2012

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)

Three Months Ended September 30,	**2012**	**2011**
Revenue	**$ 16,008**	$ 17,372
Cost of revenue	**4,168**	3,777
Gross profit	**11,840**	13,595
Operating expenses:		
Research and development	**2,460**	2,329
Sales and marketing	**2,945**	2,900
General and administrative	**1,127**	1,163
Total operating expenses	**6,532**	6,392
Operating income	**5,308**	7,203
Other income	**226**	103
Income before income taxes	**5,534**	7,306
Provision for income taxes	**1,068**	1,568
Net income	**$ 4,466**	$ 5,738
Earnings per share:		
Basic	**$ 0.53**	$ 0.68
Diluted	**$ 0.53**	$ 0.68
Weighted average shares outstanding:		
Basic	**8,396**	8,392
Diluted	**8,494**	8,490
Cash dividends declared per common share	**$ 0.23**	$ 0.20

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	**2012**	**2011**
Net income	**$ 4,466**	$ 5,738
Other comprehensive income (loss):		
Net unrealized gains (losses) on derivatives (net of tax effects of **$(24)**, and $86)	**(45)**	160
Net unrealized gains (losses) on investments (net of tax effects of **$148**, and $(619))	**274**	(1,149)
Translation adjustments and other (net of tax effects of **$91**, and $(66))	**169**	(123)
Other comprehensive income (loss)	**398**	(1,112)
Comprehensive income	**$ 4,864**	$ 4,626

See accompanying notes.

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BALANCE SHEETS

(In millions) (Unaudited)

	September 30, 2012	June 30, 2012
Assets		
Current assets:		
Cash and cash equivalents	**$ 5,036**	$ 6,938
Short-term investments (including securities loaned of **$400** and $785)	**61,608**	56,102
Total cash, cash equivalents, and short-term investments	**66,644**	63,040
Accounts receivable, net of allowance for doubtful accounts of **$265** and $389	**9,871**	15,780
Inventories	**1,624**	1,137
Deferred income taxes	**2,052**	2,035
Other	**3,860**	3,092
Total current assets	**84,051**	85,084
Property and equipment, net of accumulated depreciation of **$11,401** and $10,962	**8,329**	8,269
Equity and other investments	**10,038**	9,776
Goodwill	**14,466**	13,452
Intangible assets, net	**3,423**	3,170
Other long-term assets	**1,569**	1,520
Total assets	**$ 121,876**	$ 121,271
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,631**	$ 4,175
Current portion of long-term debt	**2,236**	1,231
Accrued compensation	**2,666**	3,875
Income taxes	**847**	789
Short-term unearned revenue	**18,295**	18,653
Securities lending payable	**415**	814
Other	**3,312**	3,151
Total current liabilities	**31,402**	32,688
Long-term debt	**9,714**	10,713
Long-term unearned revenue	**1,292**	1,406
Deferred income taxes	**2,209**	1,893
Other long-term liabilities	**8,423**	8,208
Total liabilities	**53,040**	54,908
Commitments and contingencies		

Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **8,422** and 8,381	**66,084**	65,797
Retained earnings (deficit)	**932**	(856)
Accumulated other comprehensive income	**1,820**	1,422
Total stockholders equity	**68,836**	66,363
Total liabilities and stockholders equity	**$ 121,876**	$ 121,271

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	**2012**	**2011**
Operations		
Net income	**$ 4,466**	$ 5,738
Adjustments to reconcile net income to net cash from operations:		
Depreciation, amortization, and other	**710**	726
Stock-based compensation expense	**603**	558
Net recognized losses (gains) on investments and derivatives	**11**	(30)
Excess tax benefits from stock-based compensation	**(177)**	(70)
Deferred income taxes	**38**	402
Deferral of unearned revenue	**8,209**	6,139
Recognition of unearned revenue	**(8,770)**	(7,653)
Changes in operating assets and liabilities:		
Accounts receivable	**6,156**	4,733
Inventories	**(473)**	(920)
Other current assets	**(385)**	260
Other long-term assets	**(233)**	(75)
Accounts payable	**(567)**	(442)
Other current liabilities	**(1,287)**	(993)
Other long-term liabilities	**183**	120
Net cash from operations	**8,484**	8,493
Financing		
Common stock issued	**417**	336
Common stock repurchased	**(1,632)**	(1,934)
Common stock cash dividends paid	**(1,676)**	(1,341)
Excess tax benefits from stock-based compensation	**177**	70
Net cash used in financing	**(2,714)**	(2,869)
Investing		
Additions to property and equipment	**(603)**	(436)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(1,145)**	(875)
Purchases of investments	**(20,138)**	(11,299)
Maturities of investments	**1,259**	2,825
Sales of investments	**13,307**	7,536
Securities lending payable	**(399)**	(66)
Net cash used in investing	**(7,719)**	(2,315)
Effect of exchange rates on cash and cash equivalents	**47**	(38)

Net change in cash and cash equivalents	**(1,902)**	3,271
Cash and cash equivalents, beginning of period	**6,938**	9,610
Cash and cash equivalents, end of period	**$ 5,036**	$ 12,881

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	2012	2011
Common stock and paid-in capital		
Balance, beginning of period	**$ 65,797**	$ 63,415
Common stock issued	**406**	336
Common stock repurchased	**(891)**	(824)
Stock-based compensation expense	**603**	558
Stock-based compensation income tax benefits	**167**	6
Other, net	**2**	1
Balance, end of period	**66,084**	63,492
Retained earnings (deficit)		
Balance, beginning of period	**(856)**	(8,195)
Net income	**4,466**	5,738
Common stock cash dividends	**(1,937)**	(1,683)
Common stock repurchased	**(741)**	(712)
Balance, end of period	**932**	(4,852)
Accumulated other comprehensive income		
Balance, beginning of period	**1,422**	1,863
Other comprehensive income (loss)	**398**	(1,112)
Balance, end of period	**1,820**	751
Total stockholders equity	**$ 68,836**	$ 59,391

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, comprehensive 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 2012 Form 10-K filed on July 26, 2012 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 of estimates include: loss contingencies; product warranties; the fair value of, and/or potential goodwill impairment for, our reporting units; product life cycles; useful lives of our tangible and intangible assets; allowances for doubtful accounts; allowances for product returns; 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 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.

Recasting of Certain Prior Period Information

We have recast certain prior period amounts to conform to the current period presentation, including the reclassification of accumulated other comprehensive income from retained earnings to a separate component of stockholders equity, the reclassification of cost of revenue from operating expenses to a separate line and the addition of a gross profit line in the income statements, and the recasting of segment information for immaterial movements of business activities between segments and changes in cost allocations, with no impact on consolidated net income or cash flows.

Recently Adopted Accounting Guidance

In September 2011, the Financial Accounting Standards Board (FASB) issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. We adopted this new guidance beginning July 1, 2012. Adoption of this new guidance did not have a material impact on our financial statements.

In June 2011, the FASB issued guidance on presentation of comprehensive income. The new guidance eliminated the option to report other comprehensive income and its components in the statement of changes in stockholders equity. Instead, an entity is required to present either a continuous statement of net income and other comprehensive income or in two separate but consecutive statements. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is

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presented and the statement in which other comprehensive income is presented. This guidance was amended in December 2011 when the FASB issued guidance which indefinitely defers presentation of reclassification adjustments. We adopted this new amended guidance beginning July 1, 2012. Adoption of this new amended guidance resulted only in changes to presentation of our financial statements.

Recent Accounting Guidance Not Yet Adopted

In December 2011, the FASB issued guidance enhancing disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. The new guidance will be effective for us beginning July 1, 2013. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

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, stock awards, and shared performance stock awards. The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)

Three Months Ended September 30,	**2012**	**2011**
Net income available for common shareholders (A)	**$ 4,466**	$ 5,738
Weighted average outstanding shares of common stock (B)	**8,396**	8,392
Dilutive effect of stock-based awards	**98**	98
Common stock and common stock equivalents (C)	**8,494**	8,490
Earnings Per Share		
Basic (A/B)	**$ 0.53**	$ 0.68
Diluted (A/C)	**$ 0.53**	$ 0.68

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

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. As of September 30, 2012, none of these securities had met price or other conditions that would make them eligible for conversion and therefore were excluded from the calculation of basic and diluted EPS. See Note 11 Debt for additional information.

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NOTE 3 OTHER INCOME (EXPENSE)

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

(In millions)

Three Months Ended September 30,	2012	2011
Dividends and interest income	**$ 159**	$ 211
Interest expense	**(95)**	(94)
Net recognized gains (losses) on investments	**(15)**	3
Net gains on derivatives	**4**	27
Net losses on foreign currency remeasurements	**(29)**	(40)
Other	**202**	(4)
Total	**$ 226**	$ 103

Other income for the three months ended September 30, 2012 included a gain recognized upon the divestiture of our 50% share in the MSNBC joint venture on July 13, 2012.

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

(In millions)

Three Months Ended September 30,	2012	2011
Other-than-temporary impairments of investments	**$ (90)**	$ (45)
Realized gains from sales of available-for-sale securities	**101**	200
Realized losses from sales of available-for-sale securities	**(26)**	(152)
Total	**$ (15)**	$ 3

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	Short-term Investments	Equity and Other

					Equivalents		Investments
September 30, 2012							
Cash	**$ 1,993**	**$ 0**	**$ 0**	**$ 1,993**	**$ 1,993**	**$ 0**	**$ 0**
Mutual funds	**705**	**0**	**0**	**705**	**705**	**0**	**0**
Commercial paper	**79**	**0**	**0**	**79**	**79**	**0**	**0**
Certificates of deposit	**567**	**0**	**0**	**567**	**439**	**128**	**0**
U.S. government and agency securities	**53,049**	**170**	**(1)**	**53,218**	**17**	**53,201**	**0**
Foreign government bonds	**1,004**	**21**	**(24)**	**1,001**	**103**	**898**	**0**
Mortgage-backed securities	**1,649**	**86**	**(1)**	**1,734**	**0**	**1,734**	**0**
Corporate notes and bonds	**6,651**	**282**	**(8)**	**6,925**	**1,700**	**5,225**	**0**
Municipal securities	**358**	**64**	**0**	**422**	**0**	**422**	**0**
Common and preferred stock	**6,946**	**2,316**	**(251)**	**9,011**	**0**	**0**	**9,011**
Other investments	**1,027**	**0**	**0**	**1,027**	**0**	**0**	**1,027**
Total	**$ 74,028**	**$ 2,939**	**$ (285)**	**$ 76,682**	**$ 5,036**	**$ 61,608**	**$ 10,038**

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(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2012							
Cash	$ 2,019	$ 0	$ 0	$ 2,019	$ 2,019	$ 0	$ 0
Mutual funds	820	0	0	820	820	0	0
Commercial paper	96	0	0	96	96	0	0
Certificates of deposit	744	0	0	744	342	402	0
U.S. government and agency securities	47,178	130	(2)	47,306	561	46,745	0
Foreign government bonds	1,741	18	(29)	1,730	575	1,155	0
Mortgage-backed securities	1,816	82	(2)	1,896	0	1,896	0
Corporate notes and bonds	7,799	224	(15)	8,008	2,525	5,483	0
Municipal securities	358	58	0	416	0	416	0
Common and preferred stock	6,965	2,204	(436)	8,733	0	0	8,733
Other investments	1,048	0	0	1,048	0	5	1,043
Total	$ 70,584	$ 2,716	$ (484)	$ 72,816	$ 6,938	$ 56,102	$ 9,776

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**	**Total Unrealized Losses**
September 30, 2012						
U.S. government and agency securities	**$ 178**	**$ (1)**	**$ 0**	**$ 0**	**$ 178**	**$ (1)**
Foreign government bonds	**153**	**(1)**	**123**	**(23)**	**276**	**(24)**
Mortgage-backed securities	**0**	**0**	**46**	**(1)**	**46**	**(1)**
Corporate notes and bonds	**111**	**(4)**	**83**	**(4)**	**194**	**(8)**
Common and preferred stock	**1,275**	**(154)**	**509**	**(97)**	**1,784**	**(251)**
Total	**$ 1,717**	**$ (160)**	**$ 761**	**$ (125)**	**$ 2,478**	**$ (285)**

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

June 30, 2012

U.S. government and agency securities	$ 44	$ (2)	$ 0	$ 0	$ 44	$ (2)
Foreign government bonds	657	(27)	12	(2)	669	(29)
Mortgage-backed securities	53	0	48	(2)	101	(2)
Corporate notes and bonds	640	(11)	70	(4)	710	(15)
Common and preferred stock	2,135	(329)	305	(107)	2,440	(436)
Total	$ 3,529	$ (369)	$ 435	$ (115)	$ 3,964	$ (484)

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 September 30, 2012.

At September 30, 2012 and June 30, 2012, the recorded bases of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $323 million and $313 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not possible for us to reliably estimate the fair value of these investments.

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Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
September 30, 2012		
Due in one year or less	$ 20,571	$ 20,582
Due after one year through five years	37,135	37,288
Due after five years through 10 years	3,304	3,572
Due after 10 years	2,347	2,504
Total	$ 63,357	$ 63,946

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 September 30, 2012 and June 30, 2012, the total notional amounts of these foreign exchange contracts sold were $5.9 billion and $6.7 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 September 30, 2012 and June 30, 2012, the total notional amounts of these foreign exchange contracts sold were $583 million and $1.3 billion, 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 September 30, 2012, the total notional amounts of these foreign exchange contracts purchased and sold were $3.5 billion and $4.2 billion, respectively. As of June 30, 2012, the total notional amounts of these foreign exchange contracts purchased and sold were $3.6 billion and $7.3 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 September 30, 2012, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.2 billion and $917 million, respectively. As of June 30, 2012, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.4 billion and $982 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 September 30, 2012, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.0 billion and $1.9 billion, respectively. As of June 30, 2012, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.2 billion and $1.9 billion, respectively.

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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 both September 30, 2012 and June 30, 2012, the total notional derivative amounts of mortgage contracts purchased were $1.1 billion.

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 September 30, 2012, the total notional amounts of credit contracts purchased and sold were $327 million and $466 million, respectively. As of June 30, 2012, the total notional amounts of credit contracts purchased and sold were $318 million and $456 million, respectively.

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 September 30, 2012, the total notional amounts of commodity contracts purchased and sold were $1.5 billion and $464 million, respectively. As of June 30, 2012, the total notional amounts of commodity contracts purchased and sold were $1.5 billion and $445 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 September 30, 2012, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral was required to be posted.

Fair Values of Derivative Instruments

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

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

For derivative instruments designated as cash-flow hedges, the effective portion of the gains (losses) on the derivatives is initially reported as a component of 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).

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The following tables present the gross 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)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
September 30, 2012						
Assets						
Non-designated hedge derivatives:						
Short-term investments	$ 11	$ 143	$ 20	$ 14	$ 2	$ 190
Other current assets	60	0	0	0	0	60
Total	$ 71	$ 143	$ 20	$ 14	$ 2	$ 250
Designated hedge derivatives:						
Short-term investments	$ 2	$ 0	$ 0	$ 0	$ 0	$ 2
Other current assets	77	0	0	0	0	77
Total	$ 79	$ 0	$ 0	$ 0	$ 0	$ 79
Total assets	$ 150	$ 143	$ 20	$ 14	$ 2	$ 329
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	$ (53)	$ (8)	$ (9)	$ (16)	$ (2)	$ (88)
Designated hedge derivatives:						
Other current liabilities	$ (19)	$ 0	$ 0	$ 0	$ 0	$ (19)
Total liabilities	$ (72)	$ (8)	$ (9)	$ (16)	$ (2)	$ (107)

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
June 30, 2012						
Assets						

Non-designated hedge derivatives:						
Short-term investments	$ 14	$ 162	$ 10	$ 26	$ 3	$ 215
Other current assets	85	0	0	0	0	85
Total	$ 99	$ 162	$ 10	$ 26	$ 3	$ 300
Designated hedge derivatives:						
Short-term investments	$ 6	$ 0	$ 0	$ 0	$ 0	$ 6
Other current assets	177	0	0	0	0	177
Total	$ 183	$ 0	$ 0	$ 0	$ 0	$ 183
Total assets	$ 282	$ 162	$ 10	$ 26	$ 3	$ 483
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	$ (84)	$ (19)	$ (17)	$ (21)	$ 0	$ (141)
Designated hedge derivatives:						
Other current liabilities	$ (14)	$ 0	$ 0	$ 0	$ 0	$ (14)
Total liabilities	$ (98)	$ (19)	$ (17)	$ (21)	$ 0	$ (155)

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

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Fair-Value Hedge Gains (Losses)

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

(In millions)

Three Months Ended September 30,	2012	2011
Foreign Exchange Contracts		
Derivatives	**$ (12)**	$ 44
Hedged items	**14**	(43)
Total	**$ 2**	$ 1

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)

Three Months Ended September 30,	2012	2011
Effective Portion		
Gains (losses) recognized in OCI, net of tax effect of **$(12)** and $69	**$ (23)**	$ 128
Gains (losses) reclassified from OCI into revenue	**$ 35**	$ (49)
Amount Excluded from Effectiveness Assessment and Ineffective Portion		
Gains (losses) recognized in other income (expense)	**$ (71)**	$ 62

We estimate that $76 million of net derivative gains included in OCI at September 30, 2012 will be reclassified into earnings within the following 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 ended September 30, 2012.

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). 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 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.

(In millions)

Three Months Ended September 30,	**2012**	**2011**
Foreign exchange contracts	**$ (13)**	$ (49)
Equity contracts	**2**	11
Interest-rate contracts	**18**	43
Credit contracts	**(7)**	(17)
Commodity contracts	**66**	(90)
Total	**$ 66**	$ (102)

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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 and goodwill when it is recorded at fair value due to an impairment charge. We value the Level 3 corporate bonds using internally developed valuation models, inputs to which include interest rate curves, credit spreads, stock prices, and volatilities. 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. Unobservable inputs used in all of these models are significant to the fair values of the assets and liabilities.

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

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

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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
September 30, 2012						
Assets						
Mutual funds	**$ 705**	**$ 0**	**$ 0**	**$ 705**	**$ 0**	**$ 705**
Commercial paper	**0**	**79**	**0**	**79**	**0**	**79**
Certificates of deposit	**0**	**567**	**0**	**567**	**0**	**567**
U.S. government and agency securities	**49,170**	**4,048**	**0**	**53,218**	**0**	**53,218**
Foreign government bonds	**32**	**973**	**0**	**1,005**	**0**	**1,005**
Mortgage-backed securities	**0**	**1,725**	**0**	**1,725**	**0**	**1,725**
Corporate notes and bonds	**0**	**6,757**	**17**	**6,774**	**0**	**6,774**
Municipal securities	**0**	**422**	**0**	**422**	**0**	**422**
Common and preferred stock	**8,056**	**628**	**5**	**8,689**	**0**	**8,689**
Derivatives	**6**	**323**	**0**	**329**	**(80)**	**249**
Total	**$ 57,969**	**$ 15,522**	**$ 22**	**$ 73,513**	**$ (80)**	**$ 73,433**
Liabilities						
Derivatives and other	**$ 6**	**$ 101**	**$ 0**	**$ 107**	**$ (79)**	**$ 28**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[a]	Net Fair Value
June 30, 2012						
Assets						
Mutual funds	$ 820	$ 0	$ 0	$ 820	$ 0	$ 820
Commercial paper	0	96	0	96	0	96
Certificates of deposit	0	744	0	744	0	744
U.S. government and agency securities	42,291	5,019	0	47,310	0	47,310
Foreign government bonds	31	1,703	0	1,734	0	1,734
Mortgage-backed securities	0	1,892	0	1,892	0	1,892
Corporate notes and bonds	0	7,839	9	7,848	0	7,848
Municipal securities	0	416	0	416	0	416
Common and preferred stock	7,539	877	5	8,421	0	8,421
Derivatives	16	467	0	483	(141)	342

Total	$ 50,697	$ 19,053	$ 14	$ 69,764	$ (141)	$ 69,623
Liabilities						
Derivatives and other	$ 10	$ 145	$ 0	$ 155	$ (139)	$ 16

(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 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)

	September 30, 2012	June 30, 2012
Net fair value of assets measured at fair value on a recurring basis	**$ 73,433**	$ 69,623
Cash	**1,993**	2,019
Common and preferred stock measured at fair value on a nonrecurring basis	**323**	313
Other investments measured at fair value on a nonrecurring basis	**1,027**	1,043
Less derivative assets classified as other current assets	**(98)**	(185)
Other	**4**	3
Recorded basis of investment components	**$ 76,682**	$ 72,816

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

The following tables present the changes during the periods presented 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 Ended September 30, 2012				
Balance, beginning of period	**$ 9**	**$ 5**	**$ 0**	**$ 14**
Total realized and unrealized gains:				
Included in other income (expense)	**0**	**0**	**0**	**0**
Included in other comprehensive income (loss)	**0**	**0**	**0**	**0**
Purchases	**8**	**0**	**0**	**8**
Balance, end of period	**$ 17**	**$ 5**	**$ 0**	**$ 22**
Change in unrealized gains (losses) included in other income (expense) related to assets held as of September 30, 2012	**$ 0**	**$ 0**	**$ 0**	**$ 0**

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three Months Ended September 30, 2011				
Balance, beginning of period	$ 58	$ 5	$ 20	$ 83
Total realized and unrealized gains (losses):				
Included in other income (expense)	0	0	(2)	(2)
Included in other comprehensive income (loss)	(21)	0	0	(21)
Balance, end of period	$ 37	$ 5	$ 18	$ 60
Change in unrealized gains (losses) included in other income (expense) related to assets held as of September 30, 2011	$ 0	$ 0	$ (2)	$ (2)

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

During the three months ended September 30, 2012 and 2011, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

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NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)	September 30, 2012	June 30, 2012
Raw materials	**$ 461**	$ 210
Work in process	**48**	96
Finished goods	**1,115**	831
Total	**$ 1,624**	$ 1,137

NOTE 8 BUSINESS COMBINATIONS

Yammer

On July 18, 2012, we acquired Yammer, Inc. (Yammer), a leading provider of enterprise social networks, for $1.1 billion in cash. Yammer will continue to develop its standalone service and will add an enterprise social networking service to Microsoft s portfolio of complementary cloud-based services. Our purchase price allocations are preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available, including information relating to tax matters and finalization of our valuation of identified intangible assets. The major classes of assets to which we preliminarily allocated the purchase price were goodwill of $936 million and identifiable intangible assets of $178 million. We preliminarily assigned the goodwill to the Microsoft Business Division. Yammer was consolidated into our results of operations starting on the acquisition date.

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

(In millions)		Weighted Average Life
Customer-related	**$ 77**	**6 years**
Technology-based	**67**	**4 years**
Marketing-related	**34**	**7 years**
Total	**$ 178**	**5 years**

Pro forma results of operations have not been presented because the effects of this business combination were not material to our consolidated results of operations.

NOTE 9 GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	Balance as of June 30, 2012	Acquisitions	Other	Balance as of September 30, 2012
Windows & Windows Live Division	$ 89	**$ 0**	**$ 0**	**$ 89**
Server and Tools	1,144	**0**	**0**	**1,144**
Online Services Division	223	**0**	**0**	**223**
Microsoft Business Division	6,893	**973**	**37**	**7,903**
Entertainment and Devices Division	5,103	**0**	**4**	**5,107**
Total	$ 13,452	**$ 973**	**$ 41**	**$ 14,466**

The measurement periods for purchase price allocations end as soon as information on the facts and circumstances 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.

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

NOTE 10 INTANGIBLE ASSETS

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

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
			September 30, 2012			June 30, 2012
Technology-based [a]	**$ 3,868**	**$ (2,021)**	**$ 1,847**	$ 3,550	$ (1,899)	$ 1,651
Marketing-related	**1,360**	**(159)**	**1,201**	1,325	(136)	1,189
Contract-based	**824**	**(657)**	**167**	824	(644)	180
Customer-related	**484**	**(276)**	**208**	408	(258)	150
Total	**$ 6,536**	**$ (3,113)**	**$ 3,423**	$ 6,107	$ (2,937)	$ 3,170

(a) *Technology-based intangible assets included $350 million and $177 million as of September 30, 2012 and June 30, 2012, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

Intangible assets amortization expense was $178 million and $109 million for the three months ended September 30, 2012 and 2011, respectively. Amortization of capitalized software was $40 million and $29 million for the three months ended September 30, 2012 and 2011, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held at September 30, 2012:

(In millions)	
Year Ending June 30,	
2013 (excluding the three months ended September 30, 2012)	$ 519
2014	553
2015	469
2016	361
2017	257
Thereafter	1,264
Total	$ 3,423

NOTE 11 DEBT

As of September 30, 2012, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $12.0 billion and $13.3 billion, respectively. This is compared to a carrying value and estimated fair value of $11.9 billion and $13.2 billion, respectively, as of June 30, 2012. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of both September 30, 2012 and June 30, 2012:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate
	(In millions)		
Notes			
September 27, 2013	$ 1,000	0.875%	1.000%
June 1, 2014	2,000	2.950%	3.049%
September 25, 2015	1,750	1.625%	1.795%
February 8, 2016	750	2.500%	2.642%
June 1, 2019	1,000	4.200%	4.379%
October 1, 2020	1,000	3.000%	3.137%
February 8, 2021	500	4.000%	4.082%
June 1, 2039	750	5.200%	5.240%
October 1, 2040	1,000	4.500%	4.567%
February 8, 2041	1,000	5.300%	5.361%
Total	10,750		
Convertible Debt			
June 15, 2013	1,250	0.000%	1.849%
Total	$ 12,000		

Interest on the notes is paid semi-annually. As of September 30, 2012 and June 30, 2012, the aggregate unamortized discount for our long-term debt, including the current portion, was $50 million and $56 million, respectively.

Notes

The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Initially, each $1,000 principal amount of notes was convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share. The conversion ratio is adjusted periodically for dividends in excess of the initial dividend threshold as defined in the debt agreement. As of September 30, 2012, the net carrying amount of our convertible debt was $1.2 billion and the unamortized discount was $14 million.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft s common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock, or a combination of

cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of $1.24 billion were allocated between debt for $1.18 billion and stockholders equity for $58 million with the portion in stockholders equity representing the fair value of the option to convert the debt.

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In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with an initial cap price equal to $37.16, which is adjusted periodically to mirror any adjustments to the conversion price. The purchased capped calls were valued at $40 million and recorded to stockholders equity.

NOTE 12 INCOME TAXES

Our effective tax rates were approximately 19% and 21% for the three months ended September 30, 2012 and 2011, 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, which have lower income tax rates.

The current quarter s effective tax rate is lower than our prior year s first quarter effective tax rate primarily due to the favorable impact of foreign currency exchange rate movements on our foreign tax provisions.

Tax contingencies and other tax liabilities were $7.8 billion and $7.6 billion as of September 30, 2012 and June 30, 2012, respectively, and are included in other long-term liabilities. 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 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 September 30, 2012, the primary unresolved issue relates to transfer pricing which could have a significant impact on our financial statements if not resolved favorably. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the remaining open issues will be resolved within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2011.

NOTE 13 UNEARNED REVENUE

The components of unearned revenue were as follows:

(In millions)

	September 30, 2012	**June 30, 2012**
Volume licensing programs	**$ 15,038**	$ 16,717
Other [(a)]	**4,549**	3,342
Total	**$ 19,587**	$ 20,059

(a) *Other as of September 30, 2012 includes $1.7 billion of unearned revenue associated with pre-sales of Windows 8 to original equipment manufacturers and retailers and sales of Windows 7 with an option to upgrade to Windows 8 (the Windows Deferral) and $189 million primarily associated with revenue deferred on sales of the current version of the Microsoft Office system (the Office Deferral). Other as of June 30, 2012 includes $540 million of unearned revenue associated with the Windows Deferral.*

Unearned revenue by segment was as follows:

(In millions)

	September 30, 2012	June 30, 2012
Windows & Windows Live Division	**$ 3,439**	$ 2,444
Server and Tools	**6,654**	7,445
Microsoft Business Division	**8,266**	9,015
Other segments	**1,228**	1,155
Total	**$ 19,587**	$ 20,059

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NOTE 14 COMMITMENTS AND GUARANTEES

Yahoo! Commercial Agreement

On December 4, 2009, we entered into a 10-year agreement with Yahoo! Inc. (Yahoo!) whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! websites. Microsoft provided Yahoo! with revenue per search guarantees for a period of 18 months after implementation of the Microsoft search ads platform in each country, extended by an additional 12 months for the U.S. and Canada. These guarantees are calculated, paid, and adjusted periodically and are rate guarantees, not guarantees of search volume. We expect the remaining cost of the revenue per search guarantees will be less than $100 million.

NOTE 15 CONTINGENCIES

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 United States.

All settlements in the United States have received final court approval. Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers. We estimate the total cost to resolve all of the state overcharge class action cases will range between $1.9 billion and $2.0 billion. At September 30, 2012, we have recorded a liability related to these claims of approximately $500 million, which reflects our estimated exposure of $1.9 billion less payments made to date of approximately $1.4 billion mostly for vouchers, legal fees, and administrative expenses.

The three cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In March 2010, the court in the British Columbia case certified it as a class action. In April 2011, the British Columbia Court of Appeal reversed the class certification ruling and dismissed the case, holding that indirect purchasers do not have a claim. The plaintiffs have filed an appeal to the Canadian Supreme Court, which will be heard in the fall of 2012. The other two actions have been stayed.

Other Antitrust Litigation and Claims

In November 2004, Novell, Inc. (Novell) filed a complaint in U.S. District Court for the District of Utah (later transferred to federal court in Maryland), asserting antitrust and unfair competition claims against us related to Novell s ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims in the complaint. In March 2010, the trial court granted summary judgment in favor of Microsoft as to all remaining claims. The court of appeals reversed that ruling as to one claim. Trial of that claim took place from October to December 2011 and resulted in a mistrial because the jury was unable to reach a verdict. In July 2012, the trial court granted Microsoft s motion for judgment as a matter of law. Novell has appealed this decision to the U.S. Court of Appeals for the Tenth Circuit.

Government Competition Law Matters

In December 2009, the European Commission adopted a decision that rendered legally binding commitments offered by Microsoft to address the Commission s concerns about the inclusion of Web browsing software in Windows. Among other things, Microsoft committed to display a Browser Choice Screen on Windows-based PCs in Europe where Internet Explorer is set as the default browser. Due to a technical error, we failed to deliver the requisite software to enable that display to PCs that came preinstalled with a version of Windows 7 called Windows 7 Service Pack 1. We did deliver the requisite software to PCs running the original version of Windows 7 and earlier editions of Windows.

Following notification by the Commission of reports that some PCs were not receiving the update, we promptly fixed the error and advised the Commission of what we had discovered. PCs that come preinstalled with Windows 7 Service Pack are now receiving the

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Browser Choice Screen software, as intended. On July 17, 2012, the Commission announced that it had opened proceedings to investigate whether Microsoft had failed to comply with this commitment. The Commission stated that if a company is found to have breached a legally binding commitment, the company may be fined up to 10% of its worldwide annual revenue.

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. Since then, Microsoft and Motorola have filed additional claims against each other in the ITC, in federal district courts in Seattle, Wisconsin, Florida, and California, and in courts in Germany and the United Kingdom. In April 2012, following complaints by Microsoft and Apple, the European Union s competition office opened two antitrust investigations against Motorola to determine whether it has abused certain of its standard essential patents to distort competition in breach of European Union antitrust rules. In June 2012, we received a request for information from the U.S. Federal Trade Commission (FTC) apparently related to an FTC investigation into whether Motorola s conduct violates U.S. law. The nature of the claims asserted and status of individual matters are summarized below.

International Trade Commission

The hearing in Microsoft s ITC case against Motorola took place in August 2011 on seven of the nine patents originally asserted in the complaint. In December 2011, the administrative law judge (ALJ) issued an initial determination that Motorola infringed one Microsoft patent, and recommended that the ITC issue a limited exclusion order against Motorola prohibiting importation of infringing Motorola Android devices. In May 2012, the ITC issued the limited exclusion order recommended by the ALJ, which became effective on July 18, 2012. Microsoft has appealed certain aspects of the ITC ruling adverse to Microsoft and Motorola has appealed the ITC exclusion order.

In November 2010, Motorola filed an action against Microsoft in 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 into the U.S. In April 2012, the ALJ found that Xbox products infringe four of the five patents asserted by Motorola. The ALJ subsequently recommended that the ITC issue a limited exclusion order and a cease and desist order. Both Microsoft and Motorola sought ITC review of the ALJ s findings. In June 2012, Microsoft filed a motion to terminate the investigation as to certain patents based on facts arising as the result of Google s acquisition of Motorola. The ITC determined that it would review the ALJ s initial determination in its entirety and remanded the matter to the ALJ (1) to apply certain ITC case precedent, (2) to rule on Microsoft s June 2012 motion to terminate, and (3) set a new target date for completion of the investigation. The ALJ has set a hearing for December 2012 and a new target date for a final ITC ruling in July 2013. If the ITC issues an exclusion order or cease and desist order, it will be subject to Presidential review for up to 60 days, during which Microsoft may be able to import Xbox products subject to posting a bond. If an order is issued and survives Presidential review, Microsoft may be able to mitigate the order s impact by altering Xbox products to avoid Motorola s infringement claims.

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 has been stayed pending the outcome of Microsoft s 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 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 February 2012, the Seattle District Court granted a partial summary judgment in favor of Microsoft ruling that (1) Motorola entered into binding contractual commitments with standards organizations committing to license its declared-essential patents on RAND terms and conditions; and (2) Microsoft is a third-party beneficiary of those commitments. Subsequently, the court rejected Motorola s argument that Microsoft had repudiated its right to a RAND license, and ruled a trial is needed to determine whether Motorola is in breach of its obligation to

enter into a patent license with Microsoft and, if so, the amount of the RAND royalty. In April 2012, the court issued a temporary restraining order preventing Motorola from taking steps to enforce an injunction in Germany relating to the H.264 video patents. In May 2012, the court converted that order into a

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preliminary injunction. Motorola appealed the court s injunction orders to the Court of Appeals for the Ninth Circuit, and the Court of Appeals affirmed the orders in September 2012. The Seattle court has set a trial to determine the RAND royalty to begin in November 2012.

Cases filed by Motorola in Wisconsin, California, and Florida, with the exception of one currently stayed case in Wisconsin (a companion case to Motorola s ITC action), have been transferred at Microsoft s request to the U.S District Court in Seattle. Motorola and Microsoft both seek damages as well as injunctive relief. No trial dates have been set in any of the transferred cases, and the court has stayed these cases on agreement of the parties.

In the transferred cases, Motorola asserts 15 patents are infringed by many Microsoft products including Windows Mobile 6.5 and Windows Phone 7, Windows Marketplace, Silverlight, Windows Vista and Windows 7, Exchange Server 2003 and later, Exchange ActiveSync, Windows Live Messenger, Lync Server 2010, Outlook 2010, Office 365, SQL Server, Internet Explorer 9, Xbox, and Kinect.

In the Motorola action originally filed in California, Motorola asserts that Microsoft violated antitrust laws in connection with Microsoft s assertion of patents against Motorola that Microsoft has agreed to license to certain qualifying entities on RAND terms and conditions.

In counterclaims in the patent actions brought by Motorola, Microsoft asserts 14 patents are infringed by Motorola Android devices and certain Motorola digital video recorders.

Germany

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

Two of the patents are asserted by Motorola to be 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. Motorola seeks damages and an injunction. In May 2012, the court issued an injunction relating to all H.264 capable Microsoft products in Germany. However, due to orders in the separate litigation pending in Seattle, Washington described above, Motorola is enjoined from taking steps to enforce the German injunction. Damages would be determined in later proceedings. Microsoft has appealed the rulings of the first instance court.

Motorola asserts one of the patents covers certain syncing functionality in the ActiveSync protocol employed by Windows Phone 7, Outlook Mobile, Hotmail Mobile, Exchange Online, Exchange Server, and Hotmail Server. Motorola seeks damages and an injunction. If the court rules in favor of Motorola, an injunction could be issued immediately relating to these products employing the ActiveSync protocol in Germany, which Motorola could then take steps to enforce. We expect the court to issue a ruling in February 2013. If Motorola prevails, damages would be determined in later proceedings.

Should injunction orders be issued and enforced by Motorola, Microsoft may be able to mitigate the adverse impact by altering its products to avoid Motorola s infringement claims.

In lawsuits Microsoft filed in Germany in September, October, and December 2011 and in April 2012, Microsoft asserts Motorola Android devices infringe Microsoft patents. Microsoft seeks damages and an injunction. In May, July, and September 2012, courts in Germany issued injunctions on three patents against Motorola Android devices and in May and July ruled against Microsoft on two patents. Microsoft is taking

steps to enforce the injunctions. Damages will be determined in later proceedings. Each party has appealed or is expected to appeal the rulings against it.

United Kingdom

In December 2011, Microsoft filed an action against Motorola in the High Court of Justice, Chancery Division, Patents Court, in London, England, seeking to revoke the UK part of the European patent asserted by Motorola in Germany against the ActiveSync protocol. In February 2012, Motorola counterclaimed alleging infringement of the patent and seeking damages and an injunction. A trial is expected in December 2012.

Other Patent and Intellectual Property Claims

In addition to these cases, there are approximately 60 other patent infringement cases pending against Microsoft.

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

As of September 30, 2012, we had accrued aggregate liabilities of $394 million in other current liabilities and $203 million in other long-term liabilities for all of our contingent legal matters. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $540 million 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 financial statements for the period in which the effects become reasonably estimable.

NOTE 16 STOCKHOLDERS EQUITY

Share Repurchases

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

(In millions)

Three Months Ended September 30,	**2012**	**2011**
Shares of common stock repurchased	**33**	38
Value of common stock repurchased	**$ 1,000**	$ 1,000

We repurchased all shares with cash resources. As of September 30, 2012, approximately $7.2 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

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

Declaration Date	**Dividend Per Share**	**Record Date**	**Total Amount**	**Payment Date**
			(in millions)	
September 18, 2012	$ 0.23	November 15, 2012	$ 1,937	December 13, 2012
September 20, 2011	$ 0.20	November 17, 2011	$ 1,683	December 8, 2011

The estimate of the amount to be paid as a result of the September 18, 2012 declaration was included in other current liabilities as of September 30, 2012.

NOTE 17 SEGMENT INFORMATION

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 within this note is reported on that basis. Our five segments are Windows & Windows Live Division; Server and Tools; Online Services Division; Microsoft Business Division; and Entertainment and Devices Division.

Due to the integrated structure of our business, certain revenue earned and costs incurred by one segment may benefit other segments. Revenue on certain contracts may be allocated among the segments based on the relative value of the underlying products and services. Costs that are identifiable are allocated to the segments that benefit to incent cross-collaboration among our segments so that one segment is not solely burdened by the cost of a mutually beneficial activity. Allocated costs may include those relating to development and marketing of products and services from which multiple segments benefit, or those costs relating to services performed by one segment on behalf of other segments. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated.

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In addition, certain costs incurred at a corporate level that are identifiable and that benefit our segments are allocated to them. These allocated costs include costs of: field selling; employee benefits; shared facilities services; and customer service and support. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated. Certain other corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; legal settlements and contingencies; and employee severance.

We have recast certain prior period amounts within this note to conform to the way we internally managed and monitored segment performance during the current fiscal year, reflecting immaterial movements of business activities between segments and changes in cost allocations.

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

(In millions)

Three Months Ended September 30,	**2012**	**2011**
Revenue		
Windows & Windows Live Division	**$ 4,401**	$ 4,838
Server and Tools	**4,555**	4,217
Online Services Division	**713**	658
Microsoft Business Division	**5,683**	5,618
Entertainment and Devices Division	**1,938**	1,968
Unallocated and other	**(1,282)**	73
Consolidated	**$ 16,008**	$ 17,372
Operating income (loss)		
Windows & Windows Live Division	**$ 2,805**	$ 3,235
Server and Tools	**1,754**	1,573
Online Services Division	**(359)**	(513)
Microsoft Business Division	**3,828**	3,701
Entertainment and Devices Division	**13**	351
Reconciling amounts	**(2,733)**	(1,144)
Consolidated	**$ 5,308**	$ 7,203

Reconciling amounts in the tables above and below include adjustments to conform our internal accounting policies to U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, and depreciation.

Significant reconciling items were as follows:

(In millions)

Three Months Ended September 30,	2012	2011
Corporate-level activity [(a)]	**$ (1,387)**	$ (1,175)
Revenue reconciling amounts [(b)]	**(1,349)**	28
Other	**3**	3
Total	**$ (2,733)**	$ (1,144)

(a) *Corporate-level activity excludes revenue reconciling amounts presented separately in that line item.*

(b) *Revenue reconciling amounts for the three months ended September 30, 2012 includes $1.2 billion related to the Windows Deferral and $189 million primarily related to the Office Deferral.*

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation) as of September 30, 2012, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders equity for the three-month periods ended September 30, 2012 and 2011. These interim financial statements are the responsibility of the Corporation s management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2012, and the related consolidated statements of income, cash flows, and stockholders equity for the year then ended (not presented herein); and in our report dated July 26, 2012 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2012 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Seattle, Washington

October 18, 2012

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

Note About Forward-Looking Statements

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including without limitation, the following sections: 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, woul likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled Risk Factors (Part II, Item 1A of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

OVERVIEW

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 Annual Report on Form 10-K for the year ended June 30, 2012 and our financial statements and accompanying Notes to Financial Statements.

Microsoft is a technology leader focused on helping people and businesses throughout the world realize their full potential. We create technology that transforms the way people work, play, and communicate across a wide range of computing devices.

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 and selling hardware that integrates 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, and income taxes.

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 anticipate the changing demands of customers, industry trends, and competitive forces.

Key Opportunities and Investments

We invest research and development resources in new products and services in the areas where we see significant opportunities to drive future growth. As we look forward, the capabilities and accessibility of PCs, tablets, phones, televisions, and other devices powered by rich software platforms and applications continue to grow. With this trend we believe the full potential of software will be seen and felt in how people use these devices and the associated services at work and in their personal lives.

Devices with End-User Services

We work with an ecosystem of partners to deliver a broad spectrum of Windows devices. In some cases we build our own devices, as we have chosen to do with Xbox and the recently announced Surface. In all our work with partners and on our own devices, we focus on delivering

seamless services and experiences across devices. As consumer services and hardware advance, we expect they will continue to better complement one another, connecting the devices people use daily to unique communications, productivity, and entertainment services from Microsoft and our partners and developers around the world.

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Windows 8 reflects this shift. Coming to market on October 26, 2012 on a variety of state-of-the-art hardware, Windows 8 is built to take advantage of our consumer cloud services. Windows 8 is made for both personal and professional use and unites the light, thin, and convenient aspects of a tablet with the power of a PC. For example, Xbox Music, Video, Games, and SmartGlass applications make it possible to select and experience entertainment across a range of devices by simplifying and increasing the accessibility of entertainment experiences. SkyDrive, our cloud storage solution, connects content across all of a user s devices. Bing s search technologies in Windows 8 is designed to help users get more done. Skype has a new Windows 8 application and connects directly into the new Office.

The new Office was designed for Windows 8 and takes advantage of new mobile form factors with touch and pen capabilities. It unlocks new experiences for reading, note taking, meetings, and communications and brings social experiences directly into productivity and collaboration scenarios. The combination of a Windows 8 tablet with OneNote and SkyDrive will transform how to take notes, annotate documents, and share information.

Services for the Enterprise

Today, businesses face important opportunities and challenges. Enterprise IT departments are asked to deploy technology that drives business strategy forward. They decide what solutions will make employees more productive, collaborative, and satisfied. They work to unlock business insights from a world of data. At the same time, they must manage and secure corporate information that employees access across a growing number of personal and corporate devices.

To address these opportunities, businesses look to our world-class business applications like Microsoft Dynamics, Office, Exchange, SharePoint, Lync, and our business intelligence solutions. They rely on our technology to manage employee corporate identity and to protect their corporate data. And, increasingly, businesses of all sizes are looking to Microsoft to realize the benefits of the cloud.

Helping businesses move to the cloud is one of our largest opportunities. Cloud-based solutions provide customers with software, services, and content over the Internet by way of shared computing resources located in centralized data centers. The shift to the cloud is driven by three important economies of scale: larger data centers can deploy computational resources at significantly lower cost per unit than smaller ones; larger data centers 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. Because of the improved economics, the cloud offers unique levels of elasticity and agility that enable new solutions and applications. For businesses of all sizes, the cloud creates the opportunity to focus on innovation while leaving non-differentiating activities to reliable and cost-effective providers.

Unique to Microsoft, we continue to design and deliver cloud solutions that allow our customers to move to leverage both the cloud and their on-premise assets. For example, a company can choose to deploy Office or Microsoft Dynamics on premises, as a cloud service, or a combination of both. With Windows Server 2012, Windows Azure and System Center infrastructure, businesses can deploy applications in their own datacenter, a partner s datacenter, or in Microsoft s datacenter with common security, management, and administration across all environments, with the flexibility and scale they desire. Our business customers tell us these hybrid capabilities are critical to harnessing the power of the cloud so they can reach new levels of efficiency and tap new areas of growth.

Our Future Opportunity

There are several distinct areas of technology that we are focused on driving forward. Our goal is to lead the industry in these areas over the long term, which we expect will translate to sustained growth well into the future. We are investing significant resources in:

Developing new form factors that have increasingly natural ways to use them, including touch, gestures, and speech.

Making technology more intuitive and able to act on our behalf, instead of at our command, with machine learning.

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Building and running cloud services in ways that unleash new experiences and opportunities for businesses and individuals.

Firmly establishing our Windows platform across the PC, tablet, phone, server, and cloud to drive a thriving ecosystem of developers, unify the cross-device user experience, and increase agility when bringing new advances to market.

Delivering new scenarios with improvements in how people learn, work, play, and interact with one another.

We believe the breadth of our devices and services portfolio, our large, global partner and customer base, and the growing Windows ecosystem position us to be a leader in these areas.

Economic Conditions, Challenges and Risks

As discussed above, our industry is dynamic and highly competitive. We must anticipate changes in technology and business models. Our model for growth is based on our ability to initiate and embrace disruptive technology trends, to enter new markets, both in terms of geographies and product areas, and to drive broad adoption of the products and services we develop and market.

At Microsoft, we prioritize our investments among the highest long-term growth opportunities. These investments require significant resources and are multi-year in nature. The products and services we bring to market may be developed internally, brought to market as part of a partnership or alliance, or through acquisition.

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 worldwide by offering broad customer reach, scale in resources, and competitive compensation.

Demand for our software, services, and hardware has a strong correlation to global macroeconomic factors. The current macroeconomic factors remain dynamic. See a discussion of these factors and other risks under Risk Factors (Part II, Item 1A. of this Form 10-Q).

Seasonality

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

Unearned Revenue

Quarterly and annual revenue may be impacted by the deferral of revenue. See the discussions below regarding revenue deferred on sales of the current version of the Microsoft Office system with a guarantee to be upgraded to the newest version of the Microsoft Office system at minimal or no cost (the Office Deferral), and on sales of Windows 7 with an option to upgrade to Windows 8 Pro at a discounted price upon general availability (the Windows Upgrade Offer) and pre-sales of Windows 8 to original equipment manufacturers and retailers before general availability (Windows 8 Pre-Sales) (collectively, the Windows Deferral).

RESULTS OF OPERATIONS

Summary

(In millions, except percentages and per share amounts)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Revenue	**$ 16,008**	$ 17,372	(8)%
Operating income	**$ 5,308**	$ 7,203	(26)%
Diluted earnings per share	**$ 0.53**	$ 0.68	(22)%

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Revenue decreased mainly due to the deferral of $1.2 billion of revenue related to the Windows Deferral and $189 million of revenue primarily related to the Office Deferral, as well as due to lower Xbox 360 entertainment platform revenue, offset in part by strong sales of Server and Tools products and services. Revenue for the three months ended September 30, 2012 also included revenue for Skype, which was acquired October 13, 2011.

Operating income decreased reflecting lower revenue and increased cost of revenue and research and development expenses. Cost of revenue increased $391 million or 10%, primarily due to payments made to Nokia related to joint strategic initiatives and higher headcount-related expenses, primarily related to the Server and Tools Business. Research and Development expenses increased $131 million or 6%, due mainly to higher headcount-related expenses, primarily related to the Entertainment and Devices Division, as well as increased lab and localization costs.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the U.S. (U.S. GAAP) and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 17 Segment Information of the Notes to Financial Statements (Part I, Item I of this Form 10-Q) is presented on a basis consistent with our current internal management reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. We have recast certain prior period amounts within this MD&A to conform to the way we internally managed and monitored segment performance during the current fiscal year.

Windows & Windows Live Division

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	**2011**	
Revenue	**$ 3,244**	$ 4,874	(33)%
Operating income	**$ 1,646**	$ 3,270	(50)%

Windows & Windows Live Division (Windows Division) develops and markets PC operating systems, related software and online services, and PC hardware products. This collection of software, hardware, and services is designed to simplify everyday tasks through seamless operations across the user s hardware and software and efficient browsing capabilities. Windows Division offerings consist of the Windows operating system, software and services through Windows Live, and Microsoft PC hardware products.

Excluding the impact of the Windows Deferral, approximately 75% of total Windows Division revenue comes from Windows operating system software purchased by original equipment manufacturers (OEMs) which they pre-install on equipment they sell. The remaining approximately 25% of Windows Division revenue is generated by commercial and retail sales of Windows and PC hardware products and online advertising from Windows Live.

Windows Division revenue decreased from the prior year, due mainly to the deferral of $783 million of revenue related to Windows 8 Pre-Sales and $384 million of revenue related to the Windows Upgrade Offer. Windows Division revenue was also negatively impacted by a decline in the PC market, decreased inventory levels within distribution channels as OEMs and retailers began to prepare for the Windows 8 launch, and continued higher relative growth in emerging markets, where average selling prices are lower than developed markets.

Windows Division operating income decreased, due mainly to lower revenue. Operating expenses were impacted by higher research and development expenses, which were offset by lower sales and marketing expenses. Research and development expenses increased $43 million or

10%, primarily associated with Windows 8 and Surface. Sales and marketing expenses decreased $51 million or 8%, reflecting decreased corporate marketing activities, offset in part by increased advertising of Windows.

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Server and Tools

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Revenue	**$ 4,552**	$ 4,216	8%
Operating income	**$ 1,748**	$ 1,565	12%

Server and Tools develops and markets technology and related services that enable information technology professionals and their systems to be more productive and efficient. Server and Tools product and service offerings include Windows Server, Microsoft SQL Server, Windows Azure, Visual Studio, System Center products, Windows Embedded device platforms, and Enterprise Services. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. We also offer developer tools, training, and certification. Approximately 80% of Server and Tools revenue comes from volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

Server and Tools revenue increased in both product sales and Enterprise Services. Product revenue increased $215 million or 6%, driven primarily by growth in SQL Server, System Center, and Developer Tools, reflecting continued adoption of the Windows platform. Enterprise Services revenue grew $121 million or 13%, due to growth in both Premier product support and consulting services.

Server and Tools revenue for the three months ended September 30, 2012 included an unfavorable foreign currency impact of $77 million.

Server and Tools operating income increased, primarily due to revenue growth, offset in part by higher cost of revenue and increased sales and marketing expenses. Cost of revenue increased $110 million or 12%, primarily reflecting higher headcount-related costs. Sales and marketing expenses grew $48 million or 5%, reflecting increased corporate marketing activities and fees paid to third-party enterprise software advisors.

Online Services Division

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Revenue	**$ 697**	$ 641	9%
Operating loss	**$ (364)**	$ (514)	29%

Online Services Division (OSD) develops and markets information and content designed to help people simplify tasks and make more informed decisions online, and to help advertisers connect with audiences. OSD offerings include Bing, Bing Ads, MSN, and advertiser tools. Bing and MSN generate revenue through the sale of search and display advertising, accounting for nearly all of OSD s annual revenue.

Online advertising revenue grew $83 million or 15% to $655 million, reflecting continued growth in search advertising revenue, offset in part by decreased display advertising revenue. Search revenue grew due to increased revenue per search, increased volumes reflecting general market growth, and share gains in the U.S. According to third-party sources, Bing organic U.S. market share for the month of September 2012 was

approximately 16%, and grew 120 basis points year over year. Bing-powered U.S. market share, including Yahoo! properties, was approximately 25% for the month of September 2012, down 160 basis points year over year.

OSD s operating loss was reduced by higher revenue and lower cost of revenue and sales and marketing expenses, offset in part by higher research and development expenses. Cost of revenue decreased $91 million, driven by lower Yahoo! reimbursement costs and traffic acquisition costs. Sales and marketing expenses decreased $40 million or 23%, due mainly to decreased corporate marketing activities. Research and development expenses increased $32 million or 10%, primarily reflecting higher headcount-related expenses.

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Microsoft Business Division

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Revenue	**$ 5,502**	$ 5,635	(2)%
Operating income	**$ 3,646**	$ 3,717	(2)%

Microsoft Business Division (MBD) develops and markets software and online services designed to increase personal, team, and organization productivity. MBD offerings include the Microsoft Office system (comprising mainly Office, SharePoint, Exchange, Lync, and Office 365), which generates over 90% of MBD revenue, and Microsoft Dynamics business solutions. We evaluate MBD results based upon the nature of the end user in two primary parts: business revenue, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue; and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

MBD revenue decreased, mainly reflecting $189 million of revenue deferred primarily related to the Office Deferral, offset in part by overall increased sales of the 2010 Microsoft Office system. Business revenue increased $142 million or 3%, primarily reflecting growth in multi-year volume licensing revenue and a 6% increase in Microsoft Dynamics revenue. Consumer revenue decreased $275 million or 25% driven by the Office Deferral and a decline in the PC market.

MBD revenue for the three months ended September 30, 2012 included an unfavorable foreign currency impact of $119 million.

MBD operating income decreased, mainly due to lower revenue, offset in part by decreased research and development expenses. Research and development expenses decreased $64 million or 13%, primarily due to the capitalization of certain Microsoft Office system software development costs, offset in part by increased headcount-related expenses.

Entertainment and Devices Division

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Revenue	**$ 1,946**	$ 1,961	(1)%
Operating income	**$ 19**	$ 340	(94)%

Entertainment and Devices Division (EDD) develops and markets products and services designed to entertain and connect people. EDD offerings include the Xbox 360 entertainment platform (which includes the Xbox 360 gaming and entertainment console, Kinect for Xbox 360, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories), Mediaroom (our Internet protocol television software), Skype, and Windows Phone, including related patent licensing revenue. We acquired Skype on October 13, 2011, and its results of operations from that date are reflected in our results discussed below.

EDD revenue decreased slightly, mostly due to lower Xbox 360 platform revenue, offset in part by Skype and Windows Phone revenue. Xbox 360 platform revenue decreased $418 million or 24%, due mainly to lower volumes of consoles sold and lower video game revenue, offset in part by higher Xbox LIVE revenue. We shipped 1.7 million Xbox 360 consoles during the first quarter of fiscal year 2013, compared with 2.3 million Xbox 360 consoles during the first quarter of fiscal year 2012. Video game revenue decreased primarily due to the release of Gears of War 3 in the first quarter of fiscal year 2012 with no comparable major releases in the first quarter of fiscal year 2013.

EDD operating income decreased, due mainly to higher cost of revenue and research and development expenses. Cost of revenue grew $151 million or 14%, largely due to payments made to Nokia related to joint strategic initiatives and due to the acquisition of Skype, offset in part by decreased sales of Xbox 360 consoles and lower video game royalties. Research and development expenses increased $140 million or 44%, primarily reflecting higher headcount-related expenses related to interactive entertainment and the acquisition of Skype.

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Corporate-Level Activity

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Corporate-level activity	**$ (1,387)**	$ (1,175)	(18)%

Certain corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; and legal settlements and contingencies.

Corporate-level expenses increased, due mainly to increased corporate marketing activities and higher intellectual property licensing costs, offset in part by lower legal charges.

COST OF REVENUE

Cost of Revenue

(In millions, except percentages)	Three Months Ended September 30,		Percentage Change
	2012	2011	
Cost of revenue	**$ 4,168**	$ 3,777	10%
As a percent of revenue	**26%**	22%	4ppt

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 (traffic acquisition costs); costs incurred to support and maintain Internet-based products and services including royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs.

Cost of revenue increased reflecting payments made to Nokia and higher headcount-related costs. Headcount-related expenses increased 9%, primarily related to increased Server and Tools headcount.

OPERATING EXPENSES

Research and Development

(In millions, except percentages)

	Three Months Ended September 30,		Percentage Change
	2012	**2011**	
Research and development	**$ 2,460**	$ 2,329	6%
As a percent of revenue	**15%**	13%	2ppt

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.

Research and development expenses increased, primarily reflecting a 2% increase in headcount-related expenses, as well as increased lab and localization costs.

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Sales and Marketing

(In millions, except percentages)	Three Months Ended September 30, 2012	2011	Percentage Change
Sales and marketing	**$ 2,945**	$ 2,900	2%
As a percent of revenue	**18%**	17%	1ppt

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.

Sales and marketing expenses increased slightly, primarily reflecting amortization of intangible assets, increased advertising of Windows, a 1% increase in headcount-related expenses, and fees paid to third-party enterprise software advisors, offset in part by decreased advertising and marketing of the Xbox 360 entertainment platform.

General and Administrative

(In millions, except percentages)	Three Months Ended September 30, 2012	2011	Percentage Change
General and administrative	**$ 1,127**	$ 1,163	(3)%
As a percent of revenue	**7%**	7%	0ppt

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

General and administrative expenses decreased, primarily due lower legal charges, offset in part by a 13% increase in headcount-related expenses.

OTHER INCOME (EXPENSE) AND INCOME TAXES

Other Income (Expense)

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

(In millions, except percentages)	Three Months Ended September 30,

	2012	2011
Dividends and interest income	**$ 159**	$ 211
Interest expense	**(95)**	(94)
Net recognized gains (losses) on investments	**(15)**	3
Net gains on derivatives	**4**	27
Net losses on foreign currency remeasurements	**(29)**	(40)
Other	**202**	(4)
Total	**$ 226**	$ 103

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. Gains and losses from changes in fair values of derivatives that are not designated as hedges are recognized in other income (expense). These are generally offset by unrealized gains and losses in the underlying securities in the investment portfolio and are recorded as a component of other comprehensive income.

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Other income increased primarily due to a gain recognized upon the divestiture of our 50% share in the MSNBC joint venture on July 13, 2012. Dividends and interest income decreased due to lower yields on our investments, offset in part by higher average portfolio investment balances. Net recognized gains on investments decreased, primarily due to higher other-than-temporary impairments, offset in part by gains on sales of equity and fixed-income securities. Net gains on derivatives decreased due to losses on foreign exchange contracts in the current period as compared to gains in the comparable period, offset in part by gains on commodity derivatives in the current period as compared to losses in the comparable period. Changes in foreign currency remeasurements were primarily due to currency movements net of our hedging activities.

Income Taxes

Our effective tax rates were approximately 19% and 21% for the three months ended September 30, 2012 and 2011, 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, which have lower income tax rates.

The current quarter s effective tax rate is lower than our prior year s first quarter effective tax rate primarily due to the favorable impact of foreign currency exchange rate movements on our foreign tax provisions.

Tax contingencies and other tax liabilities were $7.8 billion and $7.6 billion as of September 30, 2012 and June 30, 2012, respectively, and are included in other long-term liabilities. 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 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 September 30, 2012, the primary unresolved issue relates to transfer pricing which could have a significant impact on our financial statements if not resolved favorably. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the remaining open issues will be resolved within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2011.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $66.6 billion as of September 30, 2012, compared with $63.0 billion as of June 30, 2012. Equity and other investments were $10.0 billion as of September 30, 2012 compared to $9.8 billion as of June 30, 2012. 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. While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of September 30, 2012 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of our mortgage-backed securities is collateralized by prime residential mortgages and carries a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

We routinely monitor our financial exposure to both sovereign and non-sovereign borrowers and counterparties. Our gross exposures to our customers and investments in Portugal, Italy, Ireland, Greece, and Spain are individually and collectively not material.

Of the cash, cash equivalents, and short-term investments at September 30, 2012, approximately $58 billion was held by our foreign subsidiaries and were subject to material repatriation tax effects. The amount of cash and investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was approximately $668 million. As of September 30, 2012, approximately 83% of the short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 7% were invested in corporate notes and bonds of U.S. companies, and 3% were invested in U.S. mortgage-backed securities, all

of which are denominated in U.S. dollars.

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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 $415 million as of September 30, 2012. Our average and maximum securities lending payable balances for the three months ended September 30, 2012 were $845 million and $1.4 billion, respectively. Intra-quarter 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. treasuries. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government bonds, mortgage-backed securities, and agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured using unobservable inputs are an immaterial portion of our portfolio.

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

Cash Flows

Cash flows from operations remained flat at $8.5 billion due to increased cash collections from customers, largely offset by other changes in working capital. Cash used in financing decreased $155 million to $2.7 billion, due mainly to a $302 million decrease in cash used for common stock repurchases and a $107 million increase in excess tax benefits from stock-based compensation, partially offset by a $335 million increase in dividends paid. Cash used in investing increased $5.4 billion to $7.7 billion, due mainly to a $4.6 billion increase in cash used for net investment purchases, sales, and maturities, a $333 million increase in cash used for securities lending, and a $270 million increase in cash used for acquisition of companies and purchases of intangible assets.

Debt

We issued debt in prior periods 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 used to partially fund discretionary business acquisitions and share repurchases.

As of September 30, 2012, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $12.0 billion and $13.3 billion, respectively. This is compared to a carrying value and estimated fair value of $11.9 billion and $13.2 billion, respectively, as of June 30, 2012. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of September 30, 2012:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate
	(In millions)		
Notes			
September 27, 2013	$ 1,000	0.875%	1.000%
June 1, 2014	2,000	2.950%	3.049%
September 25, 2015	1,750	1.625%	1.795%
February 8, 2016	750	2.500%	2.642%
June 1, 2019	1,000	4.200%	4.379%
October 1, 2020	1,000	3.000%	3.137%
February 8, 2021	500	4.000%	4.082%
June 1, 2039	750	5.200%	5.240%
October 1, 2040	1,000	4.500%	4.567%
February 8, 2041	1,000	5.300%	5.361%
Total	10,750		
Convertible Debt			
June 15, 2013	1,250	0.000%	1.849%
Total	$ 12,000		

Interest on the notes is paid semi-annually. As of September 30, 2012, the aggregate unamortized discount for our long-term debt, including the current portion, was $50 million.

Notes

The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Initially, each $1,000 principal amount of notes was convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share. The conversion ratio is adjusted periodically for dividends in excess of the initial dividend threshold as defined in the debt agreement. As of September 30, 2012, the net carrying amount of our convertible debt was $1.2 billion and the unamortized discount was $14 million.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft s common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock, or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of $1.24 billion were allocated between debt for $1.18 billion and stockholders equity for $58 million with the portion in stockholders equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with an initial cap price equal to $37.16, which is adjusted periodically to mirror any adjustments to the conversion price. The purchased capped calls were valued at $40 million and recorded to stockholders equity.

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Unearned Revenue

Unearned revenue at September 30, 2012 comprised mainly 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 billing coverage period and accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at September 30, 2012 also included payments for: the Windows Deferral; post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions and prepaid points; OEM minimum commitments; Microsoft Dynamics business solutions products; Skype prepaid credits and subscriptions; the Office Deferral; 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 September 30, 2012:

(In millions)	
Three Months Ending,	
December 31, 2012	$ 7,881
March 31, 2013	6,287
June 30, 2013	3,228
September 30, 2013	899
Thereafter	1,292
Total	$ 19,587

Share Repurchases

During the three months ended September 30, 2012, we repurchased approximately 33.0 million shares of Microsoft common stock for $1.0 billion under the repurchase plan we announced on September 22, 2008. All repurchases were made using cash resources. As of September 30, 2012, approximately $7.2 billion remained of the $40.0 billion approved repurchase amount. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

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

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(in millions)	
September 18, 2012	$ 0.23	November 15, 2012	$ 1,937	December 13, 2012
September 20, 2011	$ 0.20	November 17, 2011	$ 1,683	December 8, 2011

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. To date, we have not encountered significant costs as a result of these obligations and have not accrued in our financial statements any liabilities related to these indemnifications.

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Other Planned Uses of Capital

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

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 is 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, and cash flows from operations 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 repayment schedules, 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

Recently Adopted Accounting Guidance

In September 2011, the Financial Accounting Standards Board (FASB) issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. We adopted this new guidance beginning July 1, 2012. Adoption of this new guidance did not have a material impact on our financial statements.

In June 2011, the FASB issued guidance on presentation of comprehensive income. The new guidance eliminated the option to report other comprehensive income and its components in the statement of changes in stockholders equity. Instead, an entity is required to present either a continuous statement of net income and other comprehensive income or in two separate but consecutive statements. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. This guidance was amended in December 2011 when the FASB issued guidance which indefinitely defers presentation of reclassification adjustments. We adopted this new amended guidance beginning July 1, 2012. Adoption of this new amended guidance resulted only in changes to presentation of our financial statements.

Recent Accounting Guidance Not Yet Adopted

In December 2011, the FASB issued guidance enhancing disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. The new

guidance will be effective for us beginning July 1, 2013. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

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APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

Revenue Recognition

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. A portion of revenue may be recorded as unearned due to undelivered elements. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, and the fair value of the respective elements could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

Windows 7 revenue is subject to deferral as a result of the Windows Upgrade Offer, which started June 2, 2012. The offer provides significantly discounted rights to purchase Windows 8 Pro to qualifying end-users that purchase Windows 7 PCs during the eligibility period. Microsoft is responsible for delivering Windows 8 Pro to the end customer. Accordingly, revenue related to the allocated discount for undelivered Windows 8 is deferred until it is delivered or the redemption period expires.

Microsoft Office system revenue is subject to deferral as a result of the Office Offer, which will start on October 19, 2012. The Office Offer allows customers who purchase qualifying 2010 Microsoft Office system or Office for Mac 2011 products to receive, at no cost, a one-year subscription to Office 365 Home Premium or the equivalent version of 2013 Microsoft Office system upon general availability. Small business customers in applicable markets will also be eligible for a three-month trial of Office 365 Small Business Premium. Accordingly, estimated revenue related to the undelivered 2013 Microsoft Office system and subscription services is deferred until the products and services are delivered or the redemption period expires.

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) 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 using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital.

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

Research and Development Costs

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

Legal and Other Contingencies

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

Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position 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 financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial statements.

Stock-Based Compensation

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

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

Interest Rate

Our fixed-income portfolio is diversified across credit sectors and maturities, consisting primarily of investment-grade securities. The credit risk and average maturity of the fixed-income portfolio is managed to achieve economic returns that correlate to certain global and domestic fixed-income indices. In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency and 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 accounting principles generally accepted in the United States (U.S. GAAP), but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

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.

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The following table sets forth the one-day VaR for substantially all of our positions as of September 30, 2012 and June 30, 2012 and for the three months ended September 30, 2012:

(In millions)

			Three Months Ended September 30,		
	September 30, 2012	**June 30, 2012**			**2012**
Risk Categories			**Average**	**High**	**Low**
Foreign currency	**$ 227**	$ 98	**$ 191**	**$ 256**	**$ 90**
Interest rate	**$ 78**	$ 71	**$ 74**	**$ 83**	**$ 63**
Equity	**$ 204**	$ 205	**$ 203**	**$ 211**	**$ 195**
Commodity	**$ 23**	$ 18	**$ 20**	**$ 24**	**$ 18**

Total one-day VaR for the combined risk categories was $396 million at September 30, 2012 and $292 million at June 30, 2012. The total VaR is 25% less at September 30, 2012, and 26% less at June 30, 2012 than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 15 Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding certain legal proceedings in which we are involved.

ITEM 1A. RISK FACTORS

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

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

Competition in the technology sector. Our competitors range in size from diversified global companies with significant research and development resources to small, specialized firms whose narrower product lines may let them be more effective in deploying technical, marketing, and financial resources. Barriers to entry in our businesses generally are low and software products can be distributed broadly and

quickly at relatively low cost. Many of the areas in which we compete evolve rapidly with changing and disruptive technologies, shifting user needs, and frequent introductions of new products and services. Our ability to remain competitive depends on our success in making innovative products that appeal to businesses and consumers.

Competition among platforms, ecosystems, and devices. An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A well-established ecosystem creates beneficial network effects among users, application developers, and the platform provider that can accelerate growth. Establishing significant scale in the marketplace is necessary to achieve and maintain competitive margins. The strategic importance of a vibrant ecosystem increases as we launch the Windows 8 operating system, Surface devices, and associated cloud-based services. We face significant competition from firms that provide competing platforms, applications and services.

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A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has been successful with some consumer products such as personal computers, mobile phones, gaming consoles, and digital music players. These competitors also earn revenue from services that are integrated with the hardware and software platform. We also offer vertically-integrated hardware and software products and services; however, our competitors have been in the market longer and in some cases have established significantly large user bases. Efforts to compete with the vertically integrated model will increase our cost of revenue and reduce our operating margins.

We derive substantial revenue from licenses of Windows operating systems on personal computers. The proliferation of alternative devices and form factors, in particular mobile devices such as smartphones and tablet computers, creates challenges from competing software platforms. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users may increasingly turn to these devices to perform functions that would have been performed by personal computers in the past. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract applications developers to our platforms. In addition, our Surface devices will compete with products made by our OEM partners, which may affect their commitment to our platform.

Competing platforms have applications marketplaces (sometimes referred to as stores) with scale and significant installed bases on mobile devices. These applications leverage free and user-paid services that over time result in disincentives for users to switch to competing platforms. In order to compete, we must successfully enlist developers to write applications for our marketplace and ensure that these applications have high quality, customer appeal, and value. Efforts to compete with these application marketplaces may increase our cost of revenue and lower our operating margins.

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

Under the license-based proprietary software model that generates most of our revenue, we bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from licensing our products. Many of our competitors also develop and sell software to businesses and consumers under this model and we expect this competition to continue.

Other competitors develop and offer free online services and content, and make money by selling third-party advertising. Advertising revenues fund development of products and services these competitors provide to users at no or little cost, competing directly with our revenue-generating products.

Some companies compete with us using an open source business model by modifying and then distributing open source software at nominal cost to end-users and earning revenue on advertising or complementary services and products. These firms do not bear the full costs of research and development for the software. Some open source software vendors develop software that mimics the features and functionality of our products.

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

Our increasing focus on devices and services presents execution and competitive risks. A growing part of our strategy involves cloud-based services used with smart client devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud and in some cases the user s choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our own competing cloud-based software plus services strategies. While we believe our expertise, investments in infrastructure, and the breadth

of our cloud-based services provide us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

- continuing to bring to market compelling cloud-based experiences that generate increasing traffic and market share;

- maintaining the utility, compatibility, and performance of our cloud-based services on the growing array of computing devices, including PCs, smartphones, tablets, and television-related devices;

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continuing to enhance the attractiveness of our cloud platforms to third-party developers; and

ensuring that our cloud-based services meet the reliability expectations of our customers and maintain the security of their data.

We make significant investments in new products and services that may not be profitable. We will continue to make significant investments in research, development, and marketing for existing products, services, and technologies, including the Windows operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, the Windows Store, the Windows Azure Services platform, Office 365, other cloud-based services offerings, and the Xbox 360 entertainment platform. We will also continue to invest in new software and hardware products, services, and technologies, such as the Surface set of Microsoft-designed and manufactured devices announced in June 2012. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

In fall 2012, we are launching Windows 8, a major new release of our PC operating system and Surface that seek to deliver a unique user experience through well-integrated software, hardware, and services. Its success depends on a number of factors including the extent to which customers embrace its new user interface and functionality, successfully coordinating with our OEM partners in releasing a variety of hardware devices that take advantage of its features, and attracting developers at scale to ensure a competitive array of quality applications. We expect to incur substantial marketing costs in launching Window 8 and associated services and devices, which may reduce our operating margins.

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

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

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

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Cyber-attacks and security vulnerabilities could lead to reduced revenue, increased costs, liability claims, or harm to our competitive position.

Security of Microsoft s information technology. Maintaining the security of computers and computer networks is paramount for us and our customers. Threats to information technology (IT) security can take a variety of forms. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products and services and gain access to our networks and data centers. Groups of hackers may also act in a coordinated manner to launch distributed denial of service attacks, or other coordinated attacks. Sophisticated organizations or individuals may launch targeted attacks using novel methods to gain access to computers running our software. These threats may result in breaches of our network or data security, disruptions of our internal systems and business applications, impairment of our ability to provide services to our customers, product development delays, harm to our competitive position from the compromise of confidential business information, or other negative impacts on our business.

In addition, our internal IT environment continues to evolve. Often we are early adopters of new devices and technologies. We embrace new ways of sharing data and communicating internally and with partners and customers using methods such as social networking and other consumer-oriented technologies. These practices can enhance efficiency and business insight, but they also present risks that our business policies and internal security controls may not keep pace with the speed of these changes.

Security of our customers products and services. Security threats are a particular challenge to companies like us whose business is technology products and services. The threats to our own IT infrastructure also affect our customers. Customers using our cloud services rely on the security of our infrastructure to ensure the reliability of our services and the protection of their data. Hackers tend to focus their efforts on the most popular operating systems, programs, and services, including many of ours, and we expect them to continue to do so. The security of our products and services is an important consideration in our customers purchasing decisions.

We devote significant resources to defend against security threats, both to our internal IT systems and those of our customers. These include:

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

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products and services could cause significant reputational harm and lead some customers to reduce or delay future purchases of products or subscriptions to services, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of additional products or services. Any of these actions by customers could adversely affect our revenue. Actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges. Legislative or regulatory action may increase the costs to develop or implement our products and services.

Improper disclosure of personal data could result in liability and harm our reputation. As we continue to execute our strategy of increasing the number and scale of our cloud-based offerings, we store and process increasingly large amounts of personally identifiable information of our customers. At the same time, the continued occurrence of high-profile data breaches provides evidence of an external environment increasingly hostile to information security. This environment demands that we continuously improve our design and coordination of security controls across our business groups and geographies. Despite these efforts, it is possible our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information that we or our vendors store and manage. Improper disclosure of this information could harm our reputation,

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lead to legal exposure to customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data on premise or, increasingly, in a cloud-based environment we host. We believe consumers using our email, messaging, storage, sharing, and social networking services will increasingly want efficient, centralized methods of choosing their privacy preferences and controlling their data. Perceptions that our products or services do not adequately protect the privacy of personal information could inhibit sales of our products or services, and could constrain consumer and business adoption of our cloud-based solutions.

We may experience outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic and complexity of our products and services demand more computing power. We have spent and expect to continue to spend substantial amounts to purchase or lease data centers and equipment and to upgrade our technology and network infrastructure to handle increased traffic on our websites and in our data centers, and to introduce new products and services and support existing services such as Bing, Exchange Online, Office 365, SharePoint Online, Skype, Xbox LIVE, Windows Azure, Windows Live, and Microsoft Office Web Apps. We also are growing our business of providing a platform and back-end hosting for services provided by third-party businesses to their end customers. Maintaining and expanding this infrastructure is expensive and complex. Inefficiencies or operational failures, including temporary or permanent loss of customer data, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

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

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints included limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. Although the Consent Decree and Final Judgment expired in May 2011, we expect that federal and state antitrust authorities will continue to closely scrutinize our business.

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

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

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

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

The rulings described above may be used as precedent in other competition law proceedings.

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We are subject to a variety of ongoing commitments as a result of court or administrative orders, consent decrees or other voluntary actions we have taken. If we fail to comply with these commitments we may incur litigation costs and be subject to fines or other remedial actions. For example, in July 2012 we announced that, for some PCs sold in Europe, we were not in compliance with our 2009 agreement to display a Browser Choice Screen on Windows PCs where Internet Explorer is the default browser.

Our products and online services offerings, including new technologies we develop or acquire such as Skype, are subject to government regulation in some jurisdictions, including in areas of user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear, subject to change over time, and sometimes may conflict from jurisdiction to jurisdiction. Additionally these laws and governments approach to their enforcement, as well as our products and services, are continuing to evolve. Compliance with these types of regulation may involve significant costs or require changes in products or business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop the alleged noncompliant activity.

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

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

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

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

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions to the U.S. may result in higher effective tax rates for the company. In addition, there have been proposals from Congress to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form any proposed legislation may pass, if enacted it could have a material adverse impact on our tax expense and cash flows.

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

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

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. We acquire other companies and may not realize all the economic benefit from those acquisitions, which could result in an impairment of goodwill or intangibles. Under accounting principles generally accepted in the United States (U.S. GAAP), we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations. For example, in July 2012, we announced a $6.2 billion charge for the impairment of goodwill in our Online Services Division business segment.

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

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investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments by our employees, vendors, or agents. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region, such as current uncertainties relating to European sovereign and other debt, and difficulties in staffing and managing foreign operations, may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenue.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations because of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations. Our move toward providing our customers with more services and solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged service outages on our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may result in supply chain disruptions for hardware manufacturers, either of which may adversely affect our revenue. The long-term effects of climate change on the global economy in general or the information technology industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services. New regulations may require us to find alternative compliant and cost-effective methods of distributing our products and services.

Acquisitions, joint ventures and strategic alliances may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures and strategic alliances as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we do not realize a satisfactory return on our investment, or that we experience difficulty integrating new employees, business systems, and technology, or diversion of management s attention from our other businesses. Our recent acquisition of Skype, for example, provides opportunities to enhance our existing products. The success of our integration of Skype will depend in part on our ability to provide compelling experiences that distinguish us from our competitors in both consumer and business markets. It may take longer than expected to realize the full benefits from these transactions, such as increased revenue, enhanced efficiencies, or market share, or those benefits may ultimately be smaller than anticipated or may not be realized. These events could harm our operating results or financial condition.

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

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

(c) STOCK REPURCHASES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs
				(in millions)
July 1, 2012 July 31, 2012	6,494,633	$ 29.11	6,494,633	$ 8,031
August 1, 2012 August 31, 2012	10,680,965	$ 30.16	10,680,965	$ 7,709
September 1, 2012 September 30, 2012	15,848,418	$ 30.84	15,848,418	$ 7,221
	33,024,016		33,024,016	

During the first quarter of fiscal year 2013, we repurchased 33.0 million shares of Microsoft common stock for $1.0 billion using cash resources. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of September 30, 2012, approximately $7.2 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

ITEM 6. EXHIBITS

10.18*	Form of Executive Officer Incentive Plan Stock Award Agreement under the Microsoft Corporation 2001 Stock Plan
15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase

101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

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

** *Furnished, not filed.*

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

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SIGNATURE

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

MICROSOFT CORPORATION

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

Chief Accounting Officer (Duly Authorized Officer)
October 18, 2012