

MICROSOFT CORP  
Form 10-K  
July 30, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

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**x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended June 30, 2010

**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

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**MICROSOFT CORPORATION**

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WASHINGTON  
(STATE OF INCORPORATION)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

91-1144442  
(I.R.S. ID)

(425) 882-8080

[www.microsoft.com/investor](http://www.microsoft.com/investor)

Securities registered pursuant to Section 12(b) of the Act:

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COMMON STOCK

NASDAQ

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically 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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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  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

As of December 31, 2009, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$235,244,858,633 based on the closing sale price as reported on the NASDAQ National Market System. As of July 20, 2010, there were 8,653,567,331 shares of common stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held on November 16, 2010 are incorporated by reference into Part III.

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**PART I**

Item 1

**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: Business, Management's Discussion and Analysis, and Risk Factors. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, will 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 (refer to Part I, Item 1A of this Form 10-K). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

**PART I**

**ITEM 1. BUSINESS**

**GENERAL**

Our mission is to enable people and businesses throughout the world to realize their full potential. Since the company was founded in 1975, we have worked to achieve this mission by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, hardware, and solutions that we believe deliver new opportunities, greater convenience, and enhanced value to people's lives. We do business throughout the world and have offices in more than 100 countries.

We generate revenue by developing, manufacturing, licensing, and supporting a wide range of software products and services for many different types of computing devices. Our software products and services include operating systems for personal computers, servers, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solutions applications; high-performance computing applications; software development tools; and video games. We provide consulting and product and solution support services, and we train and certify computer system integrators and developers. We also design and sell hardware including the Xbox 360 gaming and entertainment console and accessories, the Zune digital music and entertainment device and accessories, and Microsoft personal computer (PC) hardware products. In addition to selling individual products and services, we offer suites of products and services, including those discussed below and the enterprise client access license (eCAL) suite, which licenses access to Microsoft server software products.

We earn revenues from customers paying a fee to license software; that will continue to be an important part of our business, even as we develop and deliver cloud-based computing services. Cloud-based computing involves providing software, services and content over the Internet by way of shared computing resources located in centralized data centers. Consumers and business customers access these resources from a variety of devices. Revenues are earned primarily from usage fees and advertising.

Microsoft's software plus services vision reflects our belief that what is most powerful for end users is a computing or communication device running sophisticated software, interacting with cloud-based resources. Examples of consumer-oriented cloud-based computing services we offer currently include:

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Bing, our Internet search service;

Windows Live Essentials suite, which allows users to upload and organize photos, make movies, communicate via email and messaging and enhance online safety; and

Xbox LIVE service, which enables online gaming, social networking, and content access.

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Our current cloud-based services for business users include:

Microsoft Office Web Apps, which are the online companions to Microsoft Word, Excel, PowerPoint, and OneNote;

our Business Productivity Online Suite, offering communications and collaboration solutions with high availability and simplified enterprise IT management;

Microsoft Dynamics Online family of customer relationship management ( CRM ) and enterprise resources planning services; and

our Azure family of services, including a scalable operating system with compute, storage, hosting and management capabilities, a relational database, and a platform that helps developers connect applications and services in the cloud or on premise.

We also conduct research and develop advanced technologies for future software products and services. We believe that delivering breakthrough innovation and high-value solutions through our integrated software platform is the key to meeting our customers' needs and to our future growth. We believe that we will continue to lay the foundation for long-term growth by delivering new products and services, creating new opportunities for partners, improving customer satisfaction, and improving our internal processes. Our focus is to build on this foundation through ongoing innovation in our integrated software platforms; by delivering compelling value propositions to customers; by responding effectively to customer and partner needs; and by continuing to emphasize the importance of product excellence, business efficacy, and accountability.

**OPERATING SEGMENTS**

We operate our business in five segments: Windows & Windows Live Division, Server and Tools, Online Services Division, Microsoft Business Division, and Entertainment and Devices Division. Our segments provide management with a comprehensive financial view of our key businesses. The segments enable the alignment of strategies and objectives across the development, sales, marketing, and services organizations, and they provide a framework for timely and rational allocation of development, sales, marketing, and services resources within businesses.

**Windows & Windows Live Division**

Windows & Windows Live Division ( Windows Division ) has overall responsibility for development and marketing of the Windows operating system, Windows Live and Internet Explorer. Windows Division revenue growth is largely correlated to the growth of the PC market, as the original equipment manufacturer ( OEM ) distribution channel accounts for approximately 80% of total Windows Division revenue. In addition to PC market changes, Windows OEM revenue is impacted by:

hardware market changes driven by shifts between emerging markets and developed market, consumer PCs and business PCs, and the impact of lower cost netbook PCs;

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the attachment of Windows to PCs shipped and changes in inventory levels within the OEM channel; and

pricing changes and promotions, the pricing variation associated with OEM channel shifts from local and regional system builders to large, multinational OEMs, and other pricing factors.

Windows Division offerings consist of premium and standard edition Windows operating systems and online software and services through Windows Live. Premium Windows operating systems are those that include additional functionality and are sold at a price above our standard editions.

**Products and Services:** Windows operating system: Windows 7, including Home Basic, Home Premium, Professional, Ultimate, Enterprise, and Starter Edition; Windows Vista, including Home Basic, Home Premium, Ultimate, Business, Enterprise and Starter Edition; and Windows XP Home. Windows Live suite of applications and web services.



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*Competition*

The Windows operating system faces competition from various commercial software products offered by well-established companies, including Apple and Google, and from the Linux operating system. Linux is derived from Unix and is available without payment under a General Public License. Partners such as Hewlett-Packard and Intel have been actively working with alternative Linux-based operating systems.

The Windows operating system also faces competition from alternative platforms and new devices that may reduce consumer demand for PCs. User and usage volumes on mobile devices are increasing around the world relative to the PC. Competitors such as Apple, Google, Mozilla, and Opera Software Company offer software that competes with the Web browsing capabilities of Internet Explorer, a component of the Windows operating system. Our operating system products compete effectively by delivering innovative software, giving customers choice and flexibility, a familiar, easy-to-use interface, compatibility with a broad range of hardware and software applications, and the largest support network for any operating system.

Windows Live software and services compete with Google, Yahoo!, and a wide array of Web sites and portals that provide communication and sharing tools and services.

**Server and Tools**

Server and Tools develops and markets server software, software developer tools, services, and solutions that are designed to make information technology professionals and developers and their systems more productive and efficient. Server software is integrated server infrastructure and middleware designed to support software applications built on the Windows Server operating system and includes the server platform, database, storage, management and operations, service-oriented architecture platform, security and identity software. Server and Tools also builds standalone and software development lifecycle tools for software architects, developers, testers, and project managers. Server offerings can be run on-site, in a partner-hosted environment, or in a Microsoft-hosted environment. Our cloud-based services comprise a scalable operating system with compute, storage, and management capabilities and a relational database, both of which allow customers to run enterprise workloads and web applications in the cloud, as well as a platform that helps developers connect applications and services in the cloud or on premise.

Server and Tools offers a broad range of enterprise consulting and product support services ( Enterprise Services ) that assist customers in developing, deploying, and managing Microsoft server and desktop solutions. Server and Tools also provides training and certification to developers and information technology professionals for our Server and Tools, Microsoft Business Division, and Windows & Windows Live Division products and services.

Approximately 50% of Server and Tools revenue comes from annuity volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

**Products and Services:** Windows Server operating system; Windows Azure; Microsoft SQL Server; SQL Azure; Visual Studio; Silverlight; System Center products; Biz Talk Server; Microsoft Consulting Services; Premier product support services; and other products and services.

*Competition*

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

number of companies supply versions of Linux, including Novell and Red Hat.

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We have entered into business and technical collaboration agreements with Novell and other Linux providers to build, market, and support a series of solutions to enhance the interoperability of our products with their virtualization, management, and network security solutions, and to provide each other's customers with patent coverage for their respective products.

We compete to provide enterprise-wide computing solutions with several companies that offer solutions and middleware technology platforms. IBM and Oracle lead a group of companies focused on the Java Platform Enterprise Edition. Commercial software developers that provide competing server applications for PC-based distributed client/server environments include CA Technologies, IBM, and Oracle. Our Web application platform software competes with open source software such as Apache, Linux, MySQL, and PHP, and we compete against Java middleware such as Geronimo, JBoss, and Spring Framework.

Numerous commercial software vendors offer competing software applications for connectivity (both Internet and intranet), security, hosting, database, and e-business servers. System Center competes with server management and server virtualization platform providers, such as BMC, CA Technologies, Hewlett-Packard, IBM, and VMWare in the management of information technology infrastructures. Forefront products compete with CA Technologies, IBM, McAfee, Oracle, Symantec, and Trend Micro in protecting both client and server applications. SQL Server competes with products from IBM, Oracle, Sybase, and other companies in providing database, business intelligence and data warehousing solutions. Our products for software developers compete against offerings from Adobe, Borland, IBM, Oracle, other companies, and open-source projects. Competing open source projects include Eclipse (sponsored by CA Technologies, IBM, Oracle, and SAP), PHP, and Ruby on Rails, among others.

Our cloud-based services offerings also have many competitors. Windows Azure faces competition from Google, Salesforce.com, and VMWare. SQL Azure faces competition from IBM and Oracle.

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

**Online Services Division**

The Online Services Division ( OSD ) consists of online information offerings such as Bing, MSN portals and channels, as well as an online advertising platform with offerings for both publishers and advertisers. We earn revenue primarily from online advertising, including search, display, and advertiser and publisher tools. We continue to launch updated and new online offerings and expect to continue to do so in the future. During fiscal year 2010, we launched new releases of Bing, MSN and Advertising Platforms. In addition, on December 4, 2009, we entered into a definitive agreement with Yahoo! whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. We believe this agreement will allow us over time to improve the effectiveness and increase the value of our search offering through greater scale in search queries and an expanded and more competitive search and advertising marketplace.

**Products and Services:** Bing; Microsoft adCenter; MSN; and Atlas online tools for advertisers and publishers.

*Competition*

OSD competes with Google, Yahoo!, and a wide array of Web sites and portals that provide content and online offerings to end users. We compete with these organizations to provide advertising opportunities for merchants. Competitors are continuously developing Internet offerings that seek to provide more effective ways of connecting advertisers with audiences. We believe our search engine, Bing, helps users make faster, more informed decisions by providing relevant search results, expanded search services, and a broad selection of content. We have also enhanced the user interface to bring a richer search experience. We also invest in improving the scale of our advertising platform to serve both owned and operated, as well as third-party online properties. We will continue to introduce new products and services to improve the user online

experience. We believe that we can compete

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effectively by attracting new users, understanding their intent, and matching their intent with relevant content, advertiser offerings and software services. We will also attract advertisers by providing them access to targeted end-users on a high traffic network.

**Microsoft Business Division**

Microsoft Business Division ( MBD ) offerings consist of the Microsoft Office system and Microsoft Dynamics business solutions. Microsoft Office system products are designed to increase personal, team, and organization productivity through a range of programs, services, and software solutions. Growth of revenue from the Microsoft Office system offerings, which generate over 90% of MBD revenue, depends on our ability to add value to the core Office product set and to continue to expand our product offerings in other information worker areas such as content management, enterprise search, collaboration, unified communications, and business intelligence. Microsoft Dynamics products provide business solutions for financial management, customer relationship management ( CRM ), supply chain management, and analytics applications for small and mid-size businesses, large organizations, and divisions of global enterprises.

Approximately 80% of MBD revenue is generated from sales to businesses, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue. Revenue from this category generally depends upon the number of information workers in a licensed enterprise and is therefore relatively independent of the number of PCs sold in a given year. Approximately 20% of MBD revenue is derived from sales to consumers, which includes revenue from retail packaged product sales and OEM revenue. This revenue is generally affected by the level of PC shipments and product launches.

**Products and Services:** Microsoft Office; Microsoft SharePoint; and Microsoft Dynamics ERP and CRM, as well as Microsoft Office Web Apps, which are the online companions to Microsoft Word, Excel, PowerPoint and OneNote.

*Competition*

Competitors to the Microsoft Office system include many software application vendors such as Adobe, Apple, Corel, Google, IBM, Novell, Oracle, Red Hat, Zoho, and local application developers in Asia and Europe. Apple may distribute certain versions of its application software products with various models of its PCs and through its mobile devices. Corel and IBM have measurable installed bases with their office productivity products. Corel's suites, and many local software suites around the world, are aggressively priced for OEMs to preinstall them on low-priced PCs. Google provides a hosted messaging and productivity suite that competes with Microsoft Office, Microsoft Exchange, and Microsoft SharePoint, including its FAST enterprise search technology. The OpenOffice.org project provides a freely downloadable cross-platform application that also has been adapted by various commercial software vendors to sell under their brands, including IBM, Novell, Oracle, and Red Hat. Web-based offerings such as 37Signals, Adobe, AjaxWrite, gOffice, ShareOffice, Socialtext, ThinkFree, Zoho, or other small projects competing with individual applications, can also position themselves as alternatives to Microsoft Office system products.

Our Microsoft Dynamics products compete with well-known vendors such as Infor and Sage in the market focused on providing business solutions for small and mid-sized businesses. The market for large organizations and divisions of global enterprises is intensely competitive with a small number of primary vendors including Oracle and SAP. Additionally, Salesforce.com's on-demand customer relationship management offerings compete directly with Microsoft Dynamics CRM Online and Microsoft Dynamics CRM's on-premise offerings.

As we continue to respond to market demand for additional functionality and products, we will compete with additional vendors, most notably in content management and enterprise search, collaboration tools, unified communications, and business intelligence. These competitors include Autonomy, Cisco, Endeca, Google, IBM, Oracle, and SAP. We believe our products compete effectively with all of these vendors based on our strategy of providing flexible, easy to use solutions that work well with technologies our customers already have.



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**Entertainment and Devices Division**

The Entertainment and Devices Division ( EDD ) is responsible for developing, producing, and marketing: the Xbox 360 platform, including the Xbox 360 gaming and entertainment console and accessories, third-party games, games published under the Microsoft brand, and Xbox LIVE services, as well as research, sales, and support of those products and services; PC software games; online games and services; Mediaroom (our Internet protocol television software); Windows Phone and Windows Embedded device platforms; the Zune digital music and entertainment platform; application software for Apple's Macintosh computers, Microsoft PC hardware products and other devices. EDD is also responsible for all retail sales and marketing for retail packaged versions of the Microsoft Office system and the Windows operating systems.

**Products and Services:** Xbox 360 console and games; Xbox LIVE; Windows Phone; Windows Embedded device operating system; Zune; Mediaroom; and numerous consumer software and hardware products (such as Mac Office, mice, and keyboards); and Windows Automotive.

*Competition*

Entertainment and devices businesses are highly competitive, characterized by rapid product life cycles, frequent introductions of new products and titles, and the development of new technologies. The markets for our products are characterized by significant price competition. We anticipate continued pricing pressure from our competitors. From time to time, we have responded to this pressure by reducing prices on certain products. Our competitors vary in size from very small companies with limited resources to very large, diversified corporations with substantial financial and marketing resources. We compete primarily on the basis of product innovation, quality and variety, timing of product releases, and effectiveness of distribution and marketing.

Our Xbox gaming and entertainment business competes with console platforms from Nintendo and Sony, both of which have a large, established base of customers. The lifecycle for gaming and entertainment consoles averages five to 10 years. We released Xbox 360, our second generation console, in November 2005. Nintendo and Sony released new versions of their game consoles in late 2006. We believe the success of gaming and entertainment consoles is determined by the availability of games for the console, providing exclusive game content that gamers seek, the computational power and reliability of the console, and the ability to create new experiences via online services, downloadable content, and peripherals. We think the Xbox 360 is positioned well against competitive console products based on significant innovation in hardware architecture, new developer tools, online gaming services, and continued strong exclusive content from our own game franchises. In addition to competing against software published for non-Xbox platforms, our games business also competes with numerous companies that we have licensed to develop and publish software for the Xbox consoles.

Windows Phone faces competition from Apple, Google, Nokia, Openwave Systems, Palm, QUALCOMM, Research In Motion, and Symbian. The embedded operating system business is highly fragmented with many competitive offerings. Key competitors include IBM, Intel, and versions of embeddable Linux from commercial Linux vendors such as Metrowerks and MontaVista Software.

Zune competes with Apple and other manufacturers of digital music and entertainment devices. Our PC hardware products face aggressive competition from computer and other hardware manufacturers, many of which are also current or potential partners. Mediaroom faces competition primarily from a variety of competitors that provide elements of an Internet protocol television delivery platform, but that do not provide end-to-end solutions for the network operator.

Additional information on our operating segments and geographic and product information is contained in Note 22 Segment Information and Geographic Data of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

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**PART I**

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**OPERATIONS**

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

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

We contract most of our manufacturing activities for Xbox 360 and related games, Zune, various retail software packaged products, and Microsoft hardware to third parties. Our products may include some components that are available from only one or limited sources. Our Xbox 360 console includes certain key components that are supplied by a single source. The integrated central processing unit/graphics processing unit is purchased from IBM and the supporting embedded dynamic random access memory chips are purchased from Taiwan Semiconductor Manufacturing Company. Although we have chosen to initially source these key Xbox 360 components from a single supplier, we are under no obligation to exclusively source components from these vendors in the future. Beyond the exceptions noted, we generally have the ability to use other custom manufacturers if the current vendor becomes unavailable. We generally have multiple sources for raw materials, supplies, and components, and are often able to acquire component parts and materials on a volume discount basis.

**RESEARCH AND DEVELOPMENT**

During fiscal years 2010, 2009, and 2008, research and development expense was \$8.7 billion, \$9.0 billion, and \$8.2 billion, respectively. These amounts represented 14%, 15%, and 14%, respectively, of revenue in each of those years. We plan to continue to make significant investments in a broad range of research and product development efforts.

While most of our software products are developed internally, we also purchase technology, license intellectual property rights, and oversee third-party development and localization of certain products. We believe we are not materially dependent upon licenses and other agreements with third parties relating to the development of our products. Internal development allows us to maintain closer technical control over our products. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. Generally, we also create product documentation internally. We strive to obtain information as early as possible about changing usage patterns and hardware advances that may affect software design. Before releasing new software platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing.

**Investing in Business and Product Development**

Innovation is the foundation for Microsoft's success. 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. We maintain our long-term commitment to research and development across a wide spectrum of technologies, tools, and platforms spanning communication and collaboration; information access and organization; entertainment; business and e-commerce; advertising; and devices.



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Increasingly, we are taking a global approach to innovation. While our main research and development facilities are located in the United States, in Redmond, Washington, we also operate research and development facilities in other parts of the United States and around the world, including Canada, China, Denmark, England, India, Ireland, and Israel. This global approach will help us remain competitive in local markets and enable us to continue to attract top talent from across the world.

We invest in innovation by focusing on the emerging technology trends and breakthroughs that we believe offer significant opportunities to deliver value to our customers and growth for the company. Microsoft Research is one of the world's largest computer science research organizations, and works in close collaboration with top universities around the world to advance the state-of-the-art in computer science, providing us a unique perspective on future technology trends.

Based on our assessment of key technology trends and our broad focus on long-term research and development of new products and services, areas where we see significant opportunities to drive future growth include:

*Cloud computing and software plus services*

The ability to combine the power of desktop and server software with the reach of the Internet is creating important opportunities for growth in almost every one of our businesses. Accordingly, we are focused on innovation and broadening our platform to develop a cloud computing ecosystem that positions us for success in areas including virtualization, management, and security identity. We are also focused on delivering end-to-end experiences that connect users to information, communications, entertainment, and people in new ways across their lives at home, at work, and the broadest possible range of mobile scenarios through investments in datacenters; new versions of Windows and Office that are designed to support a wide range of connected scenarios; solutions for businesses that can be deployed by a customer, by a service provider like Microsoft, or by a Microsoft partner; tools for developers and Web designers; and consumer products and services including Xbox 360, Xbox LIVE, Windows Live services and Zune.

*Natural user interfaces*

The next few years will also see dramatic changes in the way people interact with technology as touch, gestures, handwriting, and speech recognition become a normal part of how we control devices. This will make technology more accessible and simpler to use and will create opportunities to reach new markets and deliver new kinds of computing experiences. Our long-term investments in natural user interfaces can be seen in products like Windows 7, the Microsoft Auto software platform and Kinect for Xbox 360. We believe sensory input is just one aspect of Natural User Interface technology, and we are researching the impact of several interaction paradigms such as contextual awareness and environmental awareness.

*New scenario innovation in key industries*

Continuing improvement in the power of computers and devices and the speed and ubiquity of networks is creating opportunities to deliver innovation that will transform a number of key industries and address significant global issues including healthcare, environmental sustainability, and education. In healthcare, for example, computing will connect personal health information to medical research and help make healthcare more preventive, personalized, and cost-effective. Today, Microsoft products such as HealthVault and Amalga help individuals manage their personal health and enable healthcare professionals to integrate research and health information so they can deliver more effective care. We also believe that we are entering a period where personal computers will play an increasingly important role in virtually every field of scientific research and discovery.

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*Intelligent computing*

As computing power increases, our ability to build software that has the intelligence to understand a user's preferences based on the tools and information they have accessed in the past and anticipate their future needs is rapidly improving. This development will enable us to deliver a new generation of software solutions that make people more productive by enabling them to focus more on what they want to accomplish and less on the steps needed to use technology.

**DISTRIBUTION, SALES, AND MARKETING**

We market and distribute our products and services primarily through the following channels: OEM; distributors and resellers; and online.

**OEM**

We license our software to OEMs for distribution as pre-installed software on new PCs. The most significant part of the OEM business for us is licensing of the Windows operating system. We also license to OEMs certain server operating systems and desktop applications such as our Microsoft Office system and consumer software products. In addition to licensing them software, we market through OEMs hardware devices and software as services, including our Windows Live Essentials suite. We have OEM agreements covering one or more of our products with virtually all of the multinational OEMs, including Acer, ASUSTek, Dell, Fujitsu, Hewlett-Packard, Lenovo, NEC, Samsung, Sony, and Toshiba, and the regional OEMs, including Medion, MSI, and Positivo. In addition, a portion of the OEM business is also conducted with system builders, which are low-volume, customized PC vendors operating in local markets.

**Distributors and Resellers**

We license software to organizations under arrangements that allow the end-user customer to acquire multiple licenses of products and services. Organizations license our products and services primarily through large account resellers ( LARs ), distributors, value-added resellers ( VARs ), OEMs, system builder channels and retailers. Additionally, solution integrators, independent software vendors, web agencies and developers advise organizations on the acquisition of licenses of our products and services. Many organizations that license products through enterprise agreements transact directly with us, with sales support from our Enterprise Software Advisor channel partners. These Enterprise Software Advisors typically are also authorized as LARs and operate as resellers for our other licensing programs. Although each type of reselling partner reaches organizations of all sizes, LARs are primarily engaged with large organizations. Distributors resell primarily to VARs and VARs typically reach the small-sized and medium-sized organizations. Some of our distributors include Ingram Micro and Tech Data, and some of our largest resellers include CDW, Dell, Insight Enterprises, and Software House International. Our Microsoft Dynamics software offerings are licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services. We distribute our retail packaged products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets. Individual consumers obtain our products primarily through retail outlets, including Best Buy, Target, and Wal-Mart. We have a network of field sales representatives and field support personnel that solicits orders from distributors and resellers, and provides product training and sales support.

Our arrangements for organizations to acquire multiple licenses of products are designed to provide them with a means of doing so without having to acquire separate packaged product through retail channels. In delivering organizational licensing arrangements to the market, we use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include:

*Open licensing*

Designed primarily for small-to-medium organizations (5 to over 250 licenses), these programs allow customers to acquire perpetual or subscription licenses and, at the customer's election, rights to future versions of software



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products over a specified time period (two or three years depending on the Open program used). The offering that conveys rights to future versions of certain software products over the contract period is called software assurance. Software assurance also provides support, tools, and training to help customers deploy and use software efficiently. Under the Open program, customers can acquire licenses only, or licenses with software assurance. They can also renew software assurance upon the expiration of existing volume licensing agreements.

*Select licensing*

Designed primarily for medium-to-large organizations (greater than 250 licenses), this program allows customers to acquire perpetual licenses and, at the customer's election, software assurance over a specified time period (generally three years or less). Similar to the Open program, the Select program allows customers to acquire licenses only, acquire licenses with software assurance, or renew software assurance upon the expiration of existing volume licensing agreements.

*Enterprise agreement licensing*

Enterprise agreements are targeted at medium and large organizations (greater than 250 licenses) that want to acquire licenses to software products, along with software assurance, for all or substantial parts of their enterprise. Enterprises can elect to either acquire perpetual licenses or, under the Enterprise Subscription program, can acquire non-perpetual, subscription agreements for a specified time period (generally three years). Online services are also available for purchase through the Enterprise agreement and subscriptions are generally structured with three year terms.

**Online**

Although client-based software will continue to be an important part of our business, increasingly we are delivering greater value to customers through cloud-based services. We have an expanding portfolio of products, services, and solutions that we market and distribute online. We provide online content and services to consumers through Bing, Windows Live Essentials suite, Microsoft Office Web Apps, our MSN portals and channels, and Xbox LIVE. We provide content and services to business users through the Microsoft Online Services platform, which includes cloud-based services such as Windows Azure, SQL Azure, Microsoft Dynamics CRM Online, SharePoint Online, Exchange Online, and Office Communications. Other services delivered online include our online advertising platform with offerings for both publishers and advertisers, as well as Microsoft Developer Networks subscription content and updates, periodic product updates, and online technical and practice readiness resources to support our partners in developing and selling our products and solutions.

**CUSTOMERS**

Our customers include individual consumers, small-sized and medium-sized organizations, enterprises, governmental institutions, educational institutions, Internet service providers, application developers, and OEMs. Consumers and small-sized and medium-sized organizations obtain our products primarily through distributors, resellers and OEMs. No sales to an individual customer accounted for more than 10% of fiscal year 2010, 2009, or 2008 revenue. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

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**EXECUTIVE OFFICERS OF THE REGISTRANT**

Our executive officers as of July 30, 2010 were as follows:

<b>Name</b>	<b>Age</b>	<b>Position with the Company</b>
Steven A. Ballmer	54	Chief Executive Officer
Lisa E. Brummel	50	Senior Vice President, Human Resources
Stephen A. Elop	46	President, Microsoft Business Division
Peter S. Klein	47	Chief Financial Officer
Robert L. Muglia	50	President, Server and Tools
Craig J. Mundie	61	Chief Research and Strategy Officer
Steven Sinofsky	44	President, Windows & Windows Live Division
Bradford L. Smith	51	Senior Vice President; General Counsel; Secretary
B. Kevin Turner	45	Chief Operating Officer

Mr. Ballmer was appointed Chief Executive Officer in January 2000. He served as President from July 1998 to February 2001. Previously, he had served as Executive Vice President, Sales and Support since February 1992. Mr. Ballmer joined Microsoft in 1980.

Ms. Brummel was named Senior Vice President, Human Resources in December 2005. She had been Corporate Vice President, Human Resources since May 2005. From May 2000 to May 2005, she had been Corporate Vice President of the Home & Retail Division. Since joining Microsoft in 1989, Ms. Brummel has held a number of management positions at Microsoft, including general manager of Consumer Productivity business, product unit manager of the Kids business, and product unit manager of Desktop and Decision reference products.

Mr. Elop was named President, Microsoft Business Division in January 2008. Prior to joining the Company, Mr. Elop served as Chief Operating Officer of Juniper Networks, Inc. from January 2007 to January 2008. From December 2005 to December 2006, he served as President of Worldwide Field Operations at Adobe Systems Inc. Mr. Elop joined Adobe following the 2005 acquisition of Macromedia Inc., where he was President and Chief Executive Officer from January 2005 to December 2005. During his almost eight-year tenure at Macromedia, Mr. Elop held many senior positions, including Chief Operating Officer, Executive Vice President of Worldwide Field Operations and General Manager of Macromedia's eBusiness division.

Mr. Klein was named Chief Financial Officer in November 2009. He served as Corporate Vice President, Chief Financial Officer, Microsoft Business Division since February 2006 and Chief Financial Officer of the Server and Tools Business Group from July 2003 to February 2006. Mr. Klein joined Microsoft in 2002.

Mr. Muglia was named President, Server and Tools in January 2009. He had been Senior Vice President, Server and Tools since October 2005. Before holding that position, he had a number of leadership positions at Microsoft, including Senior Vice President, Enterprise Storage Division since November 2001, Group Vice President, Personal Services Group since August 2000, Group Vice President, Business Productivity since December 1999, Senior Vice President, Business Productivity since March 1999, Senior Vice President, Applications and Tools since February 1998, and Corporate Vice President, Server Applications since 1997. Mr. Muglia joined Microsoft in 1988.

Mr. Mundie was named Chief Research and Strategy Officer in June 2006. He had been Senior Vice President and Chief Technical Officer, Advanced Strategies and Policy since August 2001. He was named Senior Vice President, Consumer Platforms in February 1996. Mr. Mundie

joined Microsoft in 1992.

Mr. Sinofsky was named President, Windows & Windows Live Division in July 2009. He served as Senior Vice President of the Windows and Windows Live Engineering Group since December 2006 and Senior Vice President, Office from December 1999 to December 2006. He had been Vice President, Office since December 1998. Mr. Sinofsky joined the Office team in 1994, increasing his responsibility with each subsequent release of the desktop suite. Mr. Sinofsky joined Microsoft in 1989.

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Mr. Smith was named Senior Vice President, General Counsel, and Secretary in November 2001. Mr. Smith was also named Chief Compliance Officer effective July 2002. He had been Deputy General Counsel for Worldwide Sales and previously was responsible for managing the European Law and Corporate Affairs Group, based in Paris. Mr. Smith joined Microsoft in 1993.

Mr. Turner was named Chief Operating Officer in September 2005. Before joining Microsoft, he was Executive Vice President of Wal-Mart Stores, Inc. and President and Chief Executive Officer of the Sam's Club division. From September 2001 to August 2002, he served as Executive Vice President and Chief Information Officer of Wal-Mart's Information Systems Division. From March 2000 to September 2001, he served as its Senior Vice President and Chief Information Officer of the Information Systems Division.

**EMPLOYEES**

As of June 30, 2010, we employed approximately 89,000 people on a full-time basis, 54,000 in the United States and 35,000 internationally. Of the total, 35,000 were in product research and development, 25,000 in sales and marketing, 15,000 in product support and consulting services, 5,000 in manufacturing and distribution, and 9,000 in general and administration. Our success is highly dependent on our ability to attract and retain qualified employees. None of our employees are subject to collective bargaining agreements.

**AVAILABLE INFORMATION**

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

our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission ( SEC );

information on our business strategies, financial results, and key performance indicators;

announcements of investor conferences, speeches, and events at which our executives talk about our product, service, and competitive strategies. Archives of these events are also available;

press releases on quarterly earnings, product and service announcements, legal developments, and international news;

corporate governance information including our articles, bylaws, governance guidelines, committee charters, codes of conduct and ethics, global corporate citizenship initiatives, and other governance-related policies;

other news and announcements that we may post from time to time that investors might find useful or interesting; and

opportunities to sign up for email alerts and RSS feeds to have information pushed in real time. The information found on our Web site is not part of this or any other report we file with or furnish to the SEC.



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**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.

**The cloud-based computing model presents execution and competitive risks.** We are transitioning to a computing environment characterized by 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. We are devoting significant resources to develop 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 provides 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 innovate and 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 smartphones, handheld computers, netbooks, tablets and television set top devices; and

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

**Challenges to our business models may reduce our revenues or operating margins.** Whether our software runs in the cloud or on a device, we continue to face challenges from alternative means of developing and licensing software. Under our license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. Certain open source software business models challenge our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not bear the full costs of research and development for the software. In some cases, their products may infringe patents granted to Microsoft for our inventions. To the extent open source software gains increasing market acceptance, our sales, revenue, and operating margins may decline.

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

**We face intense competition.** We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio is a competitive advantage, our competitors that are focused

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on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products, in some cases in violation of our intellectual property rights or on the basis of technical specifications for Microsoft technologies that we make available at little or no cost in

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connection with our interoperability initiatives. In response to competition, we continue to develop versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins, and operating income.

**We may not be able to adequately protect our intellectual property rights.** Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. As a result, our revenue in these markets likely will 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. To resolve these claims we may enter into royalty and licensing agreements on less favorable terms, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

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

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

engineering more secure products and services;

enhancing security and reliability features in our products and services;

helping our customers make the best use of our products and services to protect against computer viruses and other attacks;

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improving the deployment of software updates to address security vulnerabilities;

investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed;  
and

providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future

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purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, if third parties gain access to our networks or data centers they could obtain and exploit confidential business information and harm our competitive position. Finally, 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.

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

**We may experience outages, data loss and disruptions of our online services if we fail to maintain an adequate operations infrastructure.** Our increasing user traffic and complexity of our products and services demand more computing power. We have spent and expect to continue to spend substantial amounts to purchase or lease data centers and equipment and to upgrade our technology and network infrastructure to handle increased traffic on our Web sites and in our data centers, and to introduce new products and services and support existing services such as Bing, Exchange Online, SharePoint Online, Xbox LIVE, 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 include limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. We believe we are in full compliance with these rules. However, if we fail to comply with them, additional restrictions could be imposed on us that would adversely affect our business.

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.



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

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

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

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

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

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

**Delays in product development schedules may adversely affect our revenues.** The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Our increasing focus on 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.

**We make significant investments in new products and services that may not be profitable.** Our growth depends on our ability to innovate by offering new, and adding value to our existing, software and service offerings. We will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Xbox 360, Bing, Windows Server, Zune, Windows Live, the Windows Azure Services platform, and other cloud-based services offerings. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Our degree of success with Windows Phone, for example, will impact our ability to grow share of the smartphone operating system market. It will also be an important factor in supporting our strategy of delivering value to end users seamlessly over PC, phone, and TV device classes. 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.

**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



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system also relies on an extensive partner network. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, could result in sales channel disruption. Challenging economic conditions also may impair the ability of our customers to pay for products and services they have purchased. As a result, reserves for doubtful accounts and write-offs of accounts receivable may increase. We maintain an investment portfolio of various holdings, types, and maturities. These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that have affected global financial markets. If global credit and equity markets experience prolonged periods of decline, our investment portfolio may be adversely impacted and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely impact our financial results.

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

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

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions may result in higher effective tax rates for the company. In addition, there have been proposals 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 this proposed legislation will pass, if enacted it could have a material adverse impact on our tax expense and cash flow.

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

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

**We operate a global business that exposes us to additional risks.** We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside

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the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region and difficulties in staffing and managing foreign operations may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

**Catastrophic events or geo-political conditions may disrupt our business.** A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations and our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers. 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 and joint ventures may have an adverse effect on our business.** We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don't realize a satisfactory return on our investment, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management's attention from our other businesses. These events could harm our operating results or financial condition.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

We have received no written comments regarding our periodic or current reports from the staff of the SEC that were issued 180 days or more preceding the end of our fiscal year 2010 that remain unresolved.

**ITEM 2. PROPERTIES**

Our corporate offices consist of approximately 15 million square feet of office space located in King County, Washington: ten million square feet of owned space situated on approximately 500 acres of land we own at our corporate campus in Redmond, Washington and approximately five million square feet of space we lease. We own approximately two million additional square feet of office and datacenter space domestically (outside of the Puget Sound corporate campus) and lease many sites domestically totaling approximately four million square feet of office and datacenter space. We occupy many sites internationally, totaling approximately two million square feet that is owned and approximately nine million square feet that is leased. International facilities that we own include our India Development Center in Hyderabad, India; the European Operations Center in Dublin, Ireland; a Research and Development Campus in Shanghai, China; and facilities in Reading and Atherstone, UK. The largest leased office spaces include the following locations: Beijing and Shanghai, China; Tokyo, Japan; Unterschleissheim, Germany; Paris, France; Dublin, Ireland; Bangalore, India; Reading, UK; Vedbaek, Denmark; and Mississauga, Canada. In addition to the above locations, we have a disk duplication and digital distribution facility in Humacao, Puerto Rico, a facility in Singapore for our Asia Pacific Operations Center and Regional headquarters, and various product development facilities, both domestically and internationally, as described in the Research and Development section of Item 1 of this Form 10-K.



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Our facilities are fully used for current operations of all segments, and suitable additional spaces are available to accommodate expansion needs. We have a development agreement with the City of Redmond under which we may currently develop approximately 1.6 million square feet of additional facilities at our corporate campus in Redmond, Washington. In addition, we own 63 acres of undeveloped land in Issaquah, Washington, that can accommodate approximately one million square feet of office space.

**ITEM 3. LEGAL PROCEEDINGS**

See Note 17 – Contingencies of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for information regarding legal proceedings in which we are involved.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the NASDAQ Stock Market under the symbol MSFT. On July 20, 2010, there were 138,568 registered holders of record of our common stock. The high and low common stock sales prices per share were as follows:

Quarter Ended	September 30	December 31	March 31	June 30	Fiscal Year
<b>Fiscal Year 2010</b>					
High	\$ 26.25	\$ 31.50	\$ 31.24	\$ 31.58	\$ 31.58
Low	\$ 22.00	\$ 24.43	\$ 27.57	\$ 22.95	\$ 22.00
<b>Fiscal Year 2009</b>					
High	\$ 28.50	\$ 27.47	\$ 21.00	\$ 24.34	\$ 28.50
Low	\$ 23.50	\$ 17.50	\$ 14.87	\$ 18.18	\$ 14.87

**DIVIDENDS AND SHARE REPURCHASES**

See Note 18 – Stockholders' Equity of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for information regarding dividends and share repurchases.

**ITEM 6. SELECTED FINANCIAL DATA****FINANCIAL HIGHLIGHTS**

(In millions, except per share data)

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Year Ended June 30,	2010	2009	2008	2007	2006
Revenue	\$ 62,484	\$ 58,437	\$ 60,420	\$ 51,122	\$ 44,282
Operating income	\$ 24,098	\$ 20,363	\$ 22,271 <sup>(c)</sup>	\$ 18,438	\$ 16,380
Net income	\$ 18,760	\$ 14,569	\$ 17,681 <sup>(c)</sup>	\$ 14,065	\$ 12,599
Diluted earnings per share	\$ 2.10	\$ 1.62	\$ 1.87	\$ 1.42	\$ 1.20
Cash dividends declared per share	\$ 0.52	\$ 0.52	\$ 0.44	\$ 0.40	\$ 0.35
Cash and cash equivalents and short-term investments	\$ 36,788	\$ 31,447	\$ 23,662	\$ 23,411	\$ 34,161
Total assets	\$ 86,113	\$ 77,888	\$ 72,793	\$ 63,171	\$ 69,597
Long-term obligations	\$ 13,791 <sup>(a)</sup>	\$ 11,296 <sup>(b)</sup>	\$ 6,621	\$ 8,320	\$ 7,051
Stockholders' equity	\$ 46,175	\$ 39,558	\$ 36,286	\$ 31,097	\$ 40,104

(a) Includes \$1.25 billion of convertible debt securities issued in June 2010 and \$3.75 billion of debt securities issued in May 2009. See Note 12 Debt in the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

(b) Includes \$3.75 billion of debt securities issued in May 2009. See Note 12 Debt in the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

(c) Includes charge of \$1.4 billion ( 899 million) related to the fine imposed by the European Commission in February 2008.

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**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**OVERVIEW AND OUTLOOK**

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

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated approximately 40% of its annual segment revenues in our second fiscal quarter. In addition, quarterly revenues may be impacted by the deferral of revenue. See the discussions below regarding the deferral of revenue related to eligible sales of the 2007 Microsoft Office system with a guarantee to be upgraded to the 2010 Microsoft Office system at minimal or no cost (the Office 2010 Deferral ) and sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost and of Windows 7 to original equipment manufacturers and retailers before general availability (the Windows 7 Deferral ).

Global macroeconomic factors have a strong correlation to demand for our software, services, hardware, and online offerings. The unfavorable global economic environment adversely affected our business in fiscal year 2009 as consumers and businesses cut back on spending, which reduced PC shipments and IT investments. During fiscal year 2010, the environment began to improve. However, the current macroeconomic factors remain dynamic and uncertain and are likely to remain so into 2011. Irrespective of global economic conditions, we are positive about our relative market position, our current product portfolio and future product pipeline. Because we offer a wide range of products and services that enable companies to improve productivity and reduce costs, including cloud-based services, we believe that Microsoft is well-positioned to create new opportunities to increase revenue as the global economy improves. We remain focused on executing in the areas we can control by continuing to provide high value products at the lowest total cost of ownership while managing our expenses.

Technological innovation is the foundation of our long-term growth and we intend to maintain our commitment to investment in research and development, engineering excellence, and delivering high-quality products and services to customers and partners. We continue to develop innovative software applications and solutions that we believe will enhance information worker productivity, improve communication and collaboration in work groups, aid business intelligence, and streamline processes for small and mid-sized businesses. To sustain growth in the face of competition from other vendors of proprietary and open source software, our goal is to deliver products that provide the best platform for network computing software that is easiest to deploy and manage, and that is most secure with the lowest total cost of ownership.





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In addition, we continue to invest in research and development in existing and new lines of business, including cloud computing, search, online solutions, business solutions, mobile computing, communication, entertainment, and other areas that we believe may contribute to our long-term growth. We also invest in research and development of advanced technologies for future software products. We believe that delivering innovative and high-value solutions through our integrated platform is the key to meeting customer needs and to our future growth.

This long-term focus on investment in research and development has enabled us to lay a foundation for future growth by delivering innovative products, creating opportunities for partners, and improving customer satisfaction. Our focus in fiscal year 2011 is to build on this foundation and to continue to execute well in key areas through ongoing innovation on our integrated software platform, by responding effectively to customer and partner needs, and by focusing internally on product excellence, business efficacy, and accountability across the company.

**Summary of Results for Fiscal Years 2010, 2009, and 2008**

(In millions, except percentages and per share amounts)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Revenue	\$ 62,484	\$ 58,437	\$ 60,420	7%	(3)%
Operating income	\$ 24,098	\$ 20,363	\$ 22,271	18%	(9)%
Diluted earnings per share	\$ 2.10	\$ 1.62	\$ 1.87	30%	(13)%

*Fiscal year 2010 compared with fiscal year 2009*

Revenue increased mainly due to strong sales of Windows 7, which was released during fiscal year 2010, and PC market improvement. Operating income increased reflecting the change in revenue, offset in part by higher operating expenses.

Sales and marketing expenses increased \$335 million or 3%, primarily reflecting increased advertising and marketing of Windows 7 and Bing and increased sales force expenses related to Windows 7.

General and administrative expenses increased \$304 million or 8% due mainly to increased legal charges and transition expenses associated with the inception of the Yahoo! Commercial Agreement, offset in part by a reduction in headcount-related expenses.

Cost of revenue increased \$240 million or 2%, primarily reflecting increased online costs and charges resulting from the discontinuation of the KIN phone, offset in part by decreased Xbox 360 console costs and reductions in other costs due to resource management efforts.

Research and development expenses decreased \$296 million or 3%, primarily reflecting a decrease in third-party development and programming costs and increased capitalization of certain software development costs.

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Diluted earnings per share increased reflecting increased net income and the repurchase of 380 million shares during fiscal year 2010.

*Fiscal year 2009 compared with fiscal year 2008*

Revenue declined across most segments primarily driven by weakness in the global PC market and the unfavorable economic environment. Primary factors contributing to the decline include the following:

Revenue from Windows operating systems declined reflecting PC market weakness, especially PCs sold to businesses.

Revenue from our Entertainment and Devices Division decreased across most lines of business including Xbox 360 platform and PC game revenue which declined primarily as a result of decreased revenue per console due to price reductions during the prior 12 months, partially offset by increased console sales and Xbox LIVE revenue.

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The above declines were partially offset by increased server and server application revenue, reflecting recognition of deferred revenue from previously signed agreements and continued adoption of the Windows Server Platform and applications through SQL Server, Enterprise CAL Suites, and System Center products. Foreign currency exchange rates had a favorable impact of \$486 million on revenue.

Operating income decreased primarily reflecting decreased revenue. Operating expenses were flat with decreased general and administrative and sales and marketing expenses offset by increased headcount-related expenses, cost of revenue, and employee severance charges.

General and administrative expenses decreased \$1.4 billion or 28%, primarily due to decreased costs for legal settlements and contingencies. We incurred \$283 million of legal charges during the twelve months ended June 30, 2009 as compared to \$1.8 billion during the twelve months ended June 30, 2008. The prior year costs were primarily related to the European Commission fine of \$1.4 billion ( 899 million).

Sales and marketing expenses decreased \$381 million or 3%, primarily driven by the resource management program. As part of that program, we reduced marketing and advertising expenses.

Headcount-related expenses, excluding \$330 million of employee severance charges, increased 7%, driven by a 2% increase in headcount during the past 12 months and an increase in salaries and benefits for existing headcount.

Cost of revenue increased \$557 million or 5%, primarily reflecting increased online costs, including online traffic acquisition, data center and equipment, and headcount-related costs, partially offset by decreased Xbox 360 platform costs.

In January 2009, we announced and implemented a resource management program to reduce discretionary operating expenses, employee headcount, and capital expenditures. As part of this program, we announced the elimination of up to 5,000 positions in research and development, marketing, sales, finance, legal, human resources, and information technology by June 30, 2010. During fiscal year 2009, we recorded employee severance charges of \$330 million for the expected reduction in employee headcount.

Diluted earnings per share declined primarily reflecting decreased net income, partially offset by share repurchases during the prior 12 months. We repurchased 318 million shares during fiscal year 2009.

**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 22 Segment Information and Geographic Data of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) 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, including moving Windows Live from Online Services Division to Windows & Windows Live Division, and Razorfish from Online Services Division to Corporate. Razorfish was sold during the second quarter of fiscal year 2010.

**Windows & Windows Live Division**

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(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Revenue	\$ 18,491	\$ 14,974	\$ 17,211	23%	(13)%
Operating income	\$ 12,977	\$ 9,982	\$ 12,422	30%	(20)%

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

Windows Division revenue growth is largely correlated to the growth of PC purchases from original equipment manufacturers ( OEMs ) that pre-install versions of Windows operating systems because the OEM channel accounts for approximately 80% of total Windows Division revenue. The remaining approximately 20% of Windows Division revenue ( other revenue ) is generated by commercial and retail sales of Windows and online advertising from Windows Live.

*Fiscal year 2010 compared with fiscal year 2009*

Windows Division revenue increased primarily as a result of strong sales of Windows 7 and PC market improvement. We estimate total PC shipments from all sources grew approximately 16% to 18%. OEM revenue increased \$2.6 billion or 22%, while OEM license units increased 21%. The OEM revenue increase was driven by PC market growth, higher Windows attach rates across consumer and business segments, the restoration of normal OEM inventory levels, and the mix of versions of Windows licensed, offset in part by PC market changes, including stronger growth of emerging markets versus developed markets and of consumer PCs versus business PCs. Fiscal year 2009 OEM revenue reflects a \$273 million Windows 7 Deferral, as discussed under Overview and Outlook above. This amount was subsequently recognized in fiscal year 2010. Other revenue increased \$912 million or 29% driven primarily by Windows 7 retail sales.

Windows Division operating income increased as a result of increased revenue, offset in part by higher operating expenses. Cost of revenue increased \$296 million or 22%, primarily driven by royalties and other product costs. Sales and marketing expenses increased \$256 million or 11% reflecting increased advertising and marketing of Windows 7.

*Fiscal year 2009 compared with fiscal year 2008*

Windows Division revenue decreased primarily as a result of PC market weakness, especially PCs sold to businesses. OEM revenue decreased \$2.3 billion or 16% while OEM license units declined 2%. Based on our estimates, total worldwide PC shipments from all sources experienced a decline of approximately 1% to growth of approximately 2%, driven by changes in demand in emerging and developed markets.

Windows Division operating income decreased primarily reflecting decreased revenue and increased sales and marketing expenses. Sales and marketing expenses increased \$100 million or 5%, primarily reflecting increased advertising and marketing.

**Server and Tools**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Revenue	\$ 14,866	\$ 14,191	\$ 13,195	5%	8%
Operating income	\$ 5,491	\$ 4,803	\$ 4,149	14%	16%

Server and Tools licenses products, applications, tools, content, and delivers Enterprise Services, all of which are designed to make information technology professionals, developers and their systems more productive and efficient. Server and Tools product and service offerings consist of Windows Server, Microsoft SQL Server, Windows Azure

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and other cloud and server offerings. We also offer developer tools, training and certification. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. Server product offerings can be run on-site, in a partner-hosted environment, or in a Microsoft-hosted environment. We use multiple sales channels, including pre-installed OEM versions, sales through partners and sales directly to end customers. Approximately 50% of Server and Tools revenue comes from annuity volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

*Fiscal year 2010 compared with fiscal year 2009*

Server and Tools revenue increased mainly reflecting growth in product revenue. Product revenue increased \$652 million or 6%, driven primarily by growth in Windows Server, SQL Server and Enterprise CAL Suites revenue, reflecting increased revenue from annuity volume licensing agreements and continued adoption of Windows platform applications, offset in part by a decline in developer tools revenue. Enterprise Services revenue was relatively flat, with growth in Premier product support services nearly offset by decreased consulting services.

Server and Tools operating income increased due mainly to revenue growth and reduced research and development expenses, offset in part by increased cost of revenue. Research and development expenses decreased \$38 million or 2%, primarily driven by reduced third-party development and programming costs and headcount-related expenses, offset in part by increased hosting, localization and lab costs. Cost of revenue increased \$25 million.

*Fiscal year 2009 compared with fiscal year 2008*

Server and Tools revenue increased reflecting growth in both product and services revenue. Product revenue increased \$741 million or 7%, primarily driven by growth in SQL Server, Enterprise CAL Suites, and System Center revenue. This growth reflects recognition of deferred revenue from previously signed agreements and continued adoption of the Windows Server Platform and applications. Enterprise Services revenue increased \$255 million or 10%, primarily due to revenue from annuity support agreements.

Server and Tools revenue included a favorable foreign currency exchange impact of \$140 million.

Server and Tools operating income increased primarily due to growth in product revenue, partially offset by increased research and development expenses and cost of revenue. Research and development expenses increased \$242 million or 12%, primarily driven by increased headcount-related expenses. Cost of revenue increased \$82 million or 3%, reflecting the growth in support, online, and consulting services.

**Online Services Division**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Revenue	\$ 2,199	\$ 2,121	\$ 2,198	4%	(4)%
Operating loss	\$ (2,355)	\$ (1,652)	\$ (578)	(43)%	(186)%

Online Services Division ( OSD ) offerings include Bing, MSN, and advertiser and publisher tools.

*Yahoo! Commercial Agreement*

On December 4, 2009, we entered into a definitive agreement with Yahoo! whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. We believe this agreement will allow us over time to improve the effectiveness and increase the value of our search offering through greater scale in search



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queries and an expanded and more competitive search and advertising marketplace. See Note 16 Commitments and Guarantees in the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for additional information about the agreement.

*Fiscal year 2010 compared with fiscal year 2009*

OSD revenue increased reflecting increased online advertising revenue, offset in part by decreased Access revenue. Online advertising revenue increased \$146 million or 8% to \$1.9 billion, reflecting higher search and display advertising revenue, offset in part by decreased advertiser and publisher tools revenue. Access revenue decreased \$57 million or 31%, reflecting continued migration of subscribers to broadband or other competitively-priced service providers.

OSD operating loss increased due to increased operating expenses, offset in part by increased revenue. Cost of revenue increased \$565 million, primarily driven by higher online traffic acquisition costs and Yahoo! reimbursement and implementation costs. General and administrative expenses increased \$136 million. Sales and marketing expenses increased \$56 million or 5% due mainly to increased marketing of Bing, offset in part by decreased headcount-related expenses.

*Fiscal year 2009 compared with fiscal year 2008*

OSD revenue decreased primarily as a result of decreased Access revenue, partially offset by increased online advertising revenue. Access revenue decreased \$72 million or 28%, reflecting continued migration of subscribers to broadband or other competitively-priced service providers. Online advertising revenue increased \$6 million to \$1.8 billion, reflecting an increase in search revenue, partially offset by a decrease in display advertising revenue.

OSD revenue included an unfavorable foreign currency exchange impact of \$28 million.

OSD operating loss increased due to increased cost of revenue and research and development expenses, and decreased revenue. Cost of revenue increased \$700 million or 82%, primarily driven by increased online traffic acquisition, data center and equipment, and headcount-related costs. Research and development expenses increased \$153 million or 17%, primarily due to increased headcount-related expenses.

**Microsoft Business Division**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Revenue	\$ 18,642	\$ 18,910	\$ 18,899	(1)%	0%
Operating income	\$ 11,776	\$ 11,664	\$ 11,859	1%	(2)%

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

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Microsoft Dynamics revenue; and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

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*Fiscal year 2010 compared with fiscal year 2009*

MBD revenue decreased primarily as a result of the net deferral of \$254 million of revenue related to eligible sales of the 2007 Microsoft Office system with a guarantee to be upgraded to the 2010 Microsoft Office system at minimal or no cost (the Office 2010 Deferral). Consumer revenue decreased \$166 million or 5%, primarily due to the Office 2010 Deferral, offset in part by growth in the PC market and sales of the 2010 Microsoft Office system, which was launched during the fourth quarter. Business revenue decreased \$102 million or 1%, primarily reflecting a decline in licensing of the 2007 Microsoft Office system to transactional business customers, offset in part by growth in multi-year volume licensing agreement revenue and licensing of the 2010 Microsoft Office system to transactional business customers. Microsoft Dynamics revenue was flat.

MBD operating income increased due mainly to decreased operating expenses, offset in part by decreased revenue. Sales and marketing expenses decreased \$266 million or 6%, primarily driven by a decrease in corporate marketing activities. Research and development expenses decreased \$187 million or 11%, primarily as a result of capitalization of certain Microsoft Office system software development costs and lower headcount-related expenses. General and administrative expenses decreased \$53 million or 18% primarily due to expenses in the prior year associated with the acquisition of Fast Search & Transfer ASA (FAST) and lower headcount-related expenses. These decreases were offset in part by a \$126 million or 11% increase in cost of revenue, primarily driven by increased traffic acquisition costs and increased costs of providing services.

*Fiscal year 2009 compared with fiscal year 2008*

MBD revenue was flat reflecting increased business revenue offset by decreased consumer revenue. Business revenue increased \$458 million or 3%, primarily reflecting growth in volume licensing agreement revenue and included a 7% decrease in Microsoft Dynamics customer billings. The growth in volume licensing agreement revenue primarily reflects recognition of deferred revenue from previously signed agreements. Consumer revenue decreased \$447 million or 12%, primarily as a result of PC market weakness, a shift to lower-priced products, and pricing promotions on the 2007 Microsoft Office system.

MBD revenue included a favorable foreign currency exchange impact of \$378 million.

MBD operating income decreased reflecting increased cost of revenue and research and development expenses, partially offset by decreased sales and marketing expenses. Cost of revenue increased \$134 million or 14% primarily driven by expenses associated with FAST, which we acquired in April 2008, as well as online services infrastructure costs. Research and development expenses increased \$118 million or 8%, primarily driven by an increase in headcount-related expenses associated with FAST. Sales and marketing expenses decreased \$79 million or 2%, primarily driven by a decrease in corporate marketing activities and headcount-related costs associated with our corporate sales force.

**Entertainment and Devices Division**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Revenue	\$ 8,058	\$ 8,035	\$ 8,495	0%	(5)%
Operating income	\$ 679	\$ 108	\$ 445	529%	(76)%

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Entertainment and Devices Division ( EDD ) offerings include the Xbox 360 platform (which includes the Xbox 360 gaming and entertainment console, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories), the Zune digital music and entertainment platform ( Zune ), PC software games, online games and services, Mediaroom (our Internet protocol television software), Windows Phone and Windows Embedded device platforms, application software for Apple s Macintosh computers, Microsoft PC hardware products, and other devices. EDD is also responsible for all retail sales and marketing for Microsoft Office and Windows operating systems.

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*Fiscal year 2010 compared with fiscal year 2009*

EDD revenue was nearly flat reflecting increased revenue from the non-gaming portion of the business, partially offset by decreased revenue from Xbox 360 platform and PC games. Non-gaming revenue increased \$35 million or 1% primarily reflecting increased sales of Windows Embedded device platforms, offset in part by decreased Zune and Windows Phone revenue. Xbox 360 platform and PC game revenue decreased \$12 million, primarily reflecting a reduction in Xbox 360 consoles sold and revenue per console, offset in part by increased Xbox LIVE revenue. We shipped 10.3 million Xbox 360 consoles during the fiscal year 2010, compared with 11.2 million Xbox 360 consoles during fiscal year 2009.

EDD operating income increased due to reduced operating expenses. Cost of revenue decreased \$528 million or 11%, primarily due to lower Xbox 360 console costs, offset in part by increased royalty costs resulting from increased Xbox LIVE digital marketplace third-party content sales and charges resulting from the discontinuation of the KIN phone. Research and development expenses decreased \$34 million or 2%, primarily reflecting decreased third-party development and programming costs.

*Fiscal year 2009 compared with fiscal year 2008*

EDD revenue decreased across most lines of business. Revenue from our non-gaming business decreased \$300 million or 11%, primarily reflecting decreased Zune and PC hardware product revenue. Xbox 360 platform and PC game revenue decreased \$160 million or 3%, primarily as a result of decreased revenue per Xbox 360 console due to price reductions during the past 12 months, partially offset by increased Xbox 360 console sales and increased Xbox LIVE revenue. We shipped 11.2 million Xbox 360 consoles during fiscal year 2009, compared with 8.7 million Xbox 360 consoles during fiscal year 2008.

EDD revenue included an unfavorable foreign currency exchange impact of \$74 million.

EDD operating income decreased primarily due to decreased revenue and increased research and development expenses, partially offset by decreased cost of revenue. Research and development expenses increased \$275 million or 17%, primarily reflecting increased headcount-related expenses associated with the Windows Phone device platform, driven by recent acquisitions. Cost of revenue decreased \$344 million or 7%, primarily due to decreased Xbox 360 platform costs.

**Corporate-Level Activity**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Corporate-level activity	\$ (4,470)	\$ (4,542)	\$ (6,026)	2%	25%

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; legal settlements and contingencies; and employee severance.

*Fiscal year 2010 compared with fiscal year 2009*

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Corporate-level expenses decreased due mainly to employee severance charges of \$330 million incurred in the prior year, decreased partner payments, and reductions in other costs due to resource management efforts. These decreases in expenses were offset in part by an increase in legal charges and costs associated with broad-based sales and marketing activities. Legal charges were approximately \$533 million compared to \$283 million in the prior year.

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*Fiscal year 2009 compared with fiscal year 2008*

Corporate-level expenses decreased during fiscal year 2009, primarily reflecting decreased general and administrative and sales and marketing expenses, partially offset by employee severance charges of \$330 million. General and administrative expenses decreased \$1.4 billion or 36%, primarily due to decreased costs for legal settlements and contingencies. We incurred \$283 million of legal charges during fiscal year 2009 as compared to \$1.8 billion during fiscal year 2008. The prior year costs were primarily related to the European Commission fine of \$1.4 billion ( \$ 899 million). Sales and marketing expenses decreased \$513 million or 82%, reflecting the resource management program implemented in January 2009.

**OPERATING EXPENSES****Cost of Revenue**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Cost of revenue	\$ 12,395	\$ 12,155	\$ 11,598	2%	5%
As a percent of revenue	20%	21%	19%	(1)ppt	2ppt

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 Web sites and to acquire online advertising space ( traffic acquisition costs ); costs incurred to support and maintain Internet-based products and services; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs.

*Fiscal year 2010 compared with fiscal year 2009*

Cost of revenue increased reflecting higher online costs, mainly Yahoo! reimbursement and implementation costs and traffic acquisition costs, as well as increased royalty costs resulting from increased Xbox LIVE digital marketplace third-party content sales and charges resulting from the discontinuation of the KIN phone. For the current fiscal year, these costs were offset in part by lower Xbox 360 console costs and reductions in other costs due to resource management efforts.

*Fiscal year 2009 compared with fiscal year 2008*

Cost of revenue increased during fiscal year 2009, primarily reflecting increased online costs, including traffic acquisition, data center and equipment, and headcount costs, partially offset by decreased Xbox 360 platform costs.

**Research and Development**

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(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Research and development	\$ 8,714	\$ 9,010	\$ 8,164	(3)%	10%
As a percent of revenue	14%	15%	14%	(1)ppt	1ppt

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.



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*Fiscal year 2010 compared with fiscal year 2009*

Research and development expenses decreased, primarily reflecting decreased third-party development and programming costs and the capitalization of certain Microsoft Office system software development costs. These decreases were offset in part by the capitalization of certain software and development costs related to Windows 7 product development in the prior year.

*Fiscal year 2009 compared with fiscal year 2008*

Research and development expenses increased during fiscal year 2009, primarily reflecting a 13% increase in headcount-related costs.

**Sales and Marketing**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Sales and marketing	\$ 13,214	\$ 12,879	\$ 13,260	3%	(3)%
As a percent of revenue	21%	22%	22%	(1)ppt	0ppt

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

*Fiscal year 2010 compared with fiscal year 2009*

Sales and marketing expenses increased, primarily reflecting increased advertising and marketing of Windows 7 and Bing and increased sales force expenses related to Windows 7.

*Fiscal year 2009 compared with fiscal year 2008*

Sales and marketing expenses decreased, primarily driven by the resource management program implemented in January 2009.

**General and Administrative**

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
General and administrative	\$ 4,004	\$ 3,700	\$ 5,127	8%	(28)%
As a percent of revenue	6%	6%	8%	0ppt	(2)ppt

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

*Fiscal year 2010 compared with fiscal year 2009*

General and administrative expenses increased due to increased legal charges, as discussed above within Corporate-Level Activity, and transition expenses associated with the inception of the Yahoo! Commercial Agreement. These increases were offset in part by a 6% reduction in headcount-related expenses.

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*Fiscal year 2009 compared with fiscal year 2008*

General and administrative expenses decreased primarily reflecting decreased costs for legal settlements and legal contingencies. We incurred legal charges of \$283 million in fiscal year 2009, as compared with \$1.8 billion during fiscal year 2008. The fiscal year 2008 legal costs were primarily related to the European Commission fine of \$1.4 billion ( 899 million).

**Employee Severance**

In January 2009, we announced and implemented a resource management program to reduce employee headcount. We completed this program in fiscal year 2010, reducing our overall headcount by approximately 5,300 in various functions, including research and development, marketing, sales, finance, legal, human resources, and information technology. During fiscal years 2010 and 2009, we recorded employee severance expense of \$59 million and \$330 million, respectively.

**OTHER INCOME (EXPENSE) AND INCOME TAXES****Other Income (Expense)**

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

(In millions, except percentages)	2010	2009	2008	Percentage Change 2010 Versus 2009	Percentage Change 2009 Versus 2008
Dividends and interest income	\$ 843	\$ 744	\$ 994	13%	(25)%
Interest expense	(151)	(38)	(106)	(297)%	64%
Net recognized gains (losses) on investments	348	(125)	346	*	*
Net gains (losses) on derivatives	(140)	(558)	226	75%	*
Net gains (losses) on foreign currency remeasurements	1	(509)	226	*	*
Other	14	(56)	(143)	*	61%
<b>Total</b>	<b>\$ 915</b>	<b>\$ (542)</b>	<b>\$ 1,543</b>	<b>*</b>	<b>*</b>

\* *Not meaningful*

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.

*Fiscal year 2010 compared with fiscal year 2009*

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Dividends and interest income increased primarily due to higher average portfolio investment balances, offset in part by lower yields on our fixed-income investments. Interest expense increased due to our issuance of long term debt in May 2009. Net recognized gains on investments increased primarily due to lower other-than-temporary impairments, offset in part by lower gains on sales of investments in the current period. Other-than-temporary impairments were \$69 million during fiscal year 2010, as compared with \$862 million during fiscal year 2009 and decreased primarily due to improvements in market conditions. Net losses on derivatives decreased due to gains on equity and interest rate derivatives as compared to losses in the prior period and lower losses on commodity and foreign currency contracts in the current period. Net gains from foreign currency remeasurements were insignificant in fiscal year 2010 compared to net losses of \$509 million in the prior year, which had resulted from the strengthening of the U.S. dollar in the prior year. For fiscal year 2010, other includes a gain on the divestiture of Razorfish.

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*Fiscal year 2009 compared with fiscal year 2008*

Dividends and interest income decreased primarily reflecting lower interest rates on our fixed-income investments. Interest expense decreased due to lower average collateral balances on loaned securities and related rates. Net recognized losses on investments increased primarily due to higher other-than-temporary impairments that were partially offset by gains on sales of certain equity investments held in our strategic investments portfolio. Other-than-temporary impairments were \$862 million during fiscal year 2009, as compared with \$312 million during fiscal year 2008 and increased primarily due to declines in equity values as a result of deterioration in equity markets. Net losses on derivatives increased primarily due to losses on equity, commodity, and interest rate derivatives in fiscal year 2009 as compared with gains in the prior period. Net losses on foreign currency remeasurements increased due to the strengthening of the U.S. dollar, particularly in the first half of the fiscal year 2009.

**Income Taxes**

*Fiscal year 2010 compared with fiscal year 2009*

Our effective tax rates in fiscal years 2010 and 2009 were 25% and 27%, respectively. The fiscal year 2010 rate reflects a higher mix of foreign earnings taxed at lower rates.

*Fiscal year 2009 compared with fiscal year 2008*

Our effective tax rates in fiscal years 2009 and 2008 were 27% and 26%, respectively. While the fiscal year 2009 rate reflects a higher mix of foreign earnings taxed at lower rates, the rate increased from the prior year because the fiscal year 2008 rate reflects the resolution of tax positions relating to our agreement with the Internal Revenue Service ( IRS ) settling the 2000-2003 examination, partially offset by the European Commission fine which was not tax deductible. As a result of the settlement and the impact on subsequent years, we paid the IRS approximately \$4.1 billion during fiscal year 2009.

**FINANCIAL CONDITION**

Cash, cash equivalents, and short-term investments totaled \$36.8 billion as of June 30, 2010, compared with \$31.4 billion as of June 30, 2009. Equity and other investments were \$7.8 billion as of June 30, 2010, compared with \$4.9 billion as of June 30, 2009. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of 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.

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine fair value. This pricing methodology applies to our Level 1 investments, such as exchange-traded mutual funds, domestic and international equities, 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

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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.

While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of June 30, 2010 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of the mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

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

**Debt**

In September 2008, our Board of Directors authorized debt financings of up to \$6.0 billion. As of June 30, 2010, we had \$6.0 billion of issued and outstanding debt comprised of \$1.0 billion of commercial paper and \$5.0 billion of long-term debt including \$1.25 billion of convertible debt.

*Short-term Debt*

As of June 30, 2010, our \$1.0 billion of commercial paper issued and outstanding had a weighted average interest rate, including issuance costs, of 0.20% and maturities of 22 to 216 days. In November 2009, we replaced our \$2.0 billion and \$1.0 billion credit facilities with a \$2.25 billion 364-day credit facility, which expires on November 5, 2010. This facility serves as a back-up for our commercial paper program. In June 2010, we reduced the size of our credit facility from \$2.25 billion to \$1.0 billion due to the reduction in commercial paper outstanding. As of June 30, 2010, we were in compliance with the financial covenant in the credit facility agreement, which requires a coverage ratio be maintained of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facility during any of the periods presented.

*Long-term Debt*

**Notes**

As of June 30, 2010, we had issued and outstanding \$3.75 billion of debt securities as follows: \$2.0 billion aggregate principal amount of 2.95% notes due 2014, \$1.0 billion aggregate principal amount of 4.20% notes due 2019, and \$750 million aggregate principal amount of 5.20% notes due 2039 (collectively the Notes ). Interest on the Notes is payable semi-annually on June 1 and December 1 of each year to holders of record on the preceding May 15 and November 15. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

**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. The majority of the proceeds were used to repay outstanding commercial paper, leaving \$1.0 billion of commercial paper outstanding as of June 30, 2010. Each \$1,000 principal amount of notes

is convertible into 29.94 shares of Microsoft common stock at a conversion price of \$33.40 per share.



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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 a cap price initially equal to \$37.16. The purchased capped calls were valued at \$40 million and were charged to stockholders' equity.

**Unearned Revenue**

Unearned revenue at June 30, 2010 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 June 30, 2010 also included payments for: post-delivery support and consulting services to be performed in the future, Xbox LIVE subscriptions; unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis for Windows XP; Microsoft Dynamics business solutions products; technology guarantee programs, including the 2010 Microsoft Office technology guarantee program; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of June 30, 2010:

(In millions)

<b>Three Months Ending,</b>	
September 30, 2010	\$ 5,150
December 31, 2010	4,239
March 31, 2011	2,815
June 30, 2011	1,448
Thereafter	1,178
<b>Total</b>	<b>\$ 14,830</b>

**Cash Flows**

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*Fiscal year 2010 compared with fiscal year 2009*

Cash flow from operations increased \$5.0 billion, primarily due to payment of \$4.1 billion to the Internal Revenue Service in the prior year as a result of our settlement of the 2000-2003 audit examination along with increased cash received from customers in the current year. Cash used for financing increased \$5.8 billion, primarily due to a \$5.6 billion decrease in net cash proceeds from issuance and repayments of short-term and long-term debt. Financing activities also included a \$1.9 billion increase in cash used for common stock repurchases, which was offset in part

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by a \$1.7 billion increase in cash received from common stock issued. Cash used for investing decreased \$4.5 billion due to a \$3.3 billion decrease in cash used for combined investment purchases, sales, and maturities along with a \$1.1 billion decrease in additions to property and equipment.

*Fiscal year 2009 compared with fiscal year 2008*

Cash flow from operations decreased \$2.6 billion due to payment of approximately \$4.1 billion to the IRS in connection with our settlement of the 2000-2003 audit examination. This impact was partially offset by the fiscal year 2008 payment of the \$1.4 billion ( 899 million) European Commission fine. Cash used for financing decreased \$5.5 billion primarily due to \$5.7 billion of net cash proceeds from issuance of short-term and long-term debt in fiscal year 2009. Financing activities also included a \$3.2 billion decrease in common stock repurchased, which was offset by a \$2.9 billion decline in common stock issued. Cash used for investing increased \$11.2 billion due to a \$15.9 billion rise in purchases of investments along with a \$1.7 billion decrease in cash from investment sales and maturities. These impacts were partially offset by a \$7.2 billion decrease in cash paid for acquisition of companies, including the purchase of aQuantive in fiscal year 2008.

**Share Repurchases**

On September 22, 2008, we announced the completion of the two repurchase programs approved by our Board of Directors during the first quarter of fiscal year 2007 (the 2007 Programs ) to buy back up to \$40.0 billion of Microsoft common stock. On September 22, 2008, we also announced that our Board of Directors approved a new share repurchase program authorizing up to \$40.0 billion in share repurchases with an expiration date of September 30, 2013 (the 2008 Program ). As of June 30, 2010, approximately \$23.7 billion remained of the \$40.0 billion approved repurchase amount. The repurchase program may be suspended or discontinued at any time without notice.

During the periods reported, we repurchased with cash resources: 380 million shares for \$10.8 billion during fiscal year 2010; 318 million shares for \$8.2 billion during fiscal year 2009; and 402 million shares for \$12.4 billion during fiscal year 2008. All shares repurchased in fiscal year 2010 were repurchased under the 2008 Program, while all shares repurchased in fiscal year 2008 were repurchased under the 2007 Programs. Of the shares repurchased in fiscal year 2009, 101 million shares were repurchased for \$2.7 billion under the 2007 Programs, while the remainder were repurchased under the 2008 Program.

**Dividends**

During fiscal years 2010 and 2009, our Board of Directors declared the following dividends:

Declaration Date	Dividend		Total Amount	Payment Date
	Per Share	Record Date		
(In millions)				
<b>Fiscal Year 2010</b>				
September 18, 2009	\$ 0.13	November 19, 2009	\$ 1,152	December 10, 2009
December 9, 2009	\$ 0.13	February 18, 2010	\$ 1,139	March 11, 2010
March 8, 2010	\$ 0.13	May 20, 2010	\$ 1,130	June 10, 2010
June 16, 2010	\$ 0.13	August 19, 2010	\$ 1,127	September 9, 2010

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### Fiscal Year 2009

September 19, 2008	\$ 0.13	November 20, 2008	\$ 1,157	December 11, 2008
December 10, 2008	\$ 0.13	February 19, 2009	\$ 1,155	March 12, 2009
March 9, 2009	\$ 0.13	May 21, 2009	\$ 1,158	June 18, 2009
June 10, 2009	\$ 0.13	August 20, 2009	\$ 1,157	September 10, 2009

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### Off-Balance Sheet Arrangements

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. In evaluating

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

**Contractual Obligations**

The following table summarizes the payments due by fiscal year for our outstanding contractual obligations as of June 30, 2010. We expect to fund these commitments with existing cash and cash equivalents, short-term investments and cash flows from operations.

(In millions)	2011	2012-2014	2015-2017	2018 and Thereafter	Total
Long-term debt: <sup>(a)</sup>					
Principal payments	\$ 0	\$ 3,250	\$ 0	\$ 1,750	\$ 5,000
Interest payments	140	420	243	942	1,745
Construction commitments <sup>(b)</sup>	347	0	0	0	347
Operating leases <sup>(c)</sup>	437	784	407	270	1,898
Purchase commitments <sup>(d)</sup>	3,994	184	0	0	4,178
Other long-term liabilities <sup>(e)</sup>	0	72	9	1	82
<b>Total contractual obligations</b>	<b>\$ 4,918</b>	<b>\$ 4,710</b>	<b>\$ 659</b>	<b>\$ 2,963</b>	<b>\$ 13,250</b>

(a) See Note 12 Debt of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K)

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

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

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

(e) We have excluded long-term tax contingencies and other tax liabilities of \$7.1 billion and other long-term contingent liabilities of \$236 million (related to the antitrust and unfair competition class action lawsuits) from the amounts presented, as the amounts that will be settled in cash are not known and the timing of any payments is uncertain. We have also excluded unearned revenue of \$1.2 billion and non-cash items of \$240 million.

**Other Planned Uses of Capital**

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

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

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maintenance of a balance sheet with a large component of cash and cash equivalents, short-term investments, and equity and other investments, reflects our views on potential future capital requirements relating to research and development, creation and expansion of sales distribution channels, investments and acquisitions, share dilution management, legal risks, and challenges to our business model. We regularly assess our investment management approach in view of our current and potential future needs.

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As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was \$16.7 billion at June 30, 2010. Our retained deficit is not expected to affect our future ability to operate, pay dividends, or repay our debt given our continuing profitability and strong cash and financial position.

**RECENT LEGISLATION**

In March 2010, the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 were signed into law in the United States. This legislation expands health care coverage to many uninsured individuals and expands coverage to those already insured. The changes required by this legislation will largely be funded through tax increases to both insurers and the insured. We do not expect any near term impact on our financial results as a result of the legislation. One provision that will impact certain companies significantly is the elimination of the tax deductibility of the Medicare Part D subsidy. This provision does not affect us because we do not provide retiree health benefits.

**RECENTLY ISSUED ACCOUNTING STANDARDS**

**Recently Adopted Accounting Pronouncements**

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

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

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

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

**Recent Accounting Pronouncements Not Yet Adopted**

In October 2009, the FASB issued guidance on revenue recognition that will become effective for us beginning July 1, 2010. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality

of the tangible product will no longer be within the scope



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of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe adoption of this new guidance will not have a material impact on our financial statements.

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

**APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Our financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States ( 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, stock-based compensation, and product warranties.

**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. The amount of revenue allocated to undelivered elements is based on the VSOE of fair value for those elements using the residual method or relative fair value method, and the deferred revenue is recognized as the elements are delivered. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product 's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

A portion of the revenue related to Windows XP is recorded as unearned due to the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. Revenue related to Windows Vista and Windows 7 is not subject to a similar deferral because there are no significant undelivered elements. 2007 Microsoft Office system revenue is subject to deferral as a result of the 2010 Microsoft Office system technology guarantee program, which started March 5, 2010. This program allows customers who purchased certain versions of the 2007 Microsoft Office system to receive an upgrade to the corresponding version of the 2010 Microsoft Office system at minimal or no cost when the product becomes generally available. Accordingly, estimated revenue related to the undelivered 2010 Microsoft Office system is deferred until the product is delivered.

**Impairment of Investment Securities**

Investments are reviewed quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed income securities, we also evaluate whether we have plans to

sell the security or it is more likely than not that we will be required to sell the security before recovery.

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We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

**Goodwill**

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

In addition to the impairment test performed on May 1, 2010, we performed an interim impairment analysis of our Online Services Division goodwill balance during the first quarter of fiscal year 2010 in connection with the disposal of Razorfish. No impairment of goodwill was identified.

**Research and Development Costs**

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

**Legal and Other Contingencies**

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

**Income Taxes**

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. We

recognize the tax benefit from an uncertain tax

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

**Stock-Based Compensation**

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

**Product Warranties**

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

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

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

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

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

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

Steven A. Ballmer

Chief Executive Officer

Peter S. Klein

Chief Financial Officer

Frank H. Brod

Corporate Vice President, Finance and Administration;

Chief Accounting Officer

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Item 7A

**ITEM 7A. QUANTATIVE 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.

The following table sets forth the one-day VaR for substantially all of our positions as of June 30, 2010 and 2009 and for the year ended June 30, 2010:

(In millions)

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Year Ended June 30,

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	June 30, 2010	June 30, 2009	2010		
Risk Categories			Average	High	Low
Foreign currency	\$ 57	\$ 68	\$ 53	\$ 86	\$ 20
Interest rate	\$ 58	\$ 42	\$ 54	\$ 69	\$ 43
Equity	\$ 183	\$ 157	\$ 184	\$ 206	\$ 142
Commodity	\$ 19	\$ 16	\$ 17	\$ 20	\$ 14

Total one-day VaR for the combined risk categories was \$235 million at June 30, 2010 and \$211 million at June 30, 2009. The total VaR is 26% less at June 30, 2010, and 25% less at June 30, 2009, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.



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## Item 8

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA****INCOME STATEMENTS**

(In millions, except per share amounts)

Year Ended June 30,	2010	2009	2008
Revenue	\$ 62,484	\$ 58,437	\$ 60,420
Operating expenses:			
Cost of revenue	12,395	12,155	11,598
Research and development	8,714	9,010	8,164
Sales and marketing	13,214	12,879	13,260
General and administrative	4,004	3,700	5,127
Employee severance	59	330	0
<b>Total operating expenses</b>	<b>38,386</b>	<b>38,074</b>	<b>38,149</b>
Operating income	24,098	20,363	22,271
Other income (expense)	915	(542)	1,543
Income before income taxes	25,013	19,821	23,814
Provision for income taxes	6,253	5,252	6,133
<b>Net income</b>	<b>\$ 18,760</b>	<b>\$ 14,569</b>	<b>\$ 17,681</b>
Earnings per share:			
Basic	\$ 2.13	\$ 1.63	\$ 1.90
Diluted	\$ 2.10	\$ 1.62	\$ 1.87
Weighted average shares outstanding:			
Basic	8,813	8,945	9,328
Diluted	8,927	8,996	9,470
Cash dividends declared per common share	\$ 0.52	\$ 0.52	\$ 0.44

See accompanying notes.

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**BALANCE SHEETS**

(In millions)

June 30,	2010	2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 5,505	\$ 6,076
Short-term investments (including securities loaned of \$62 and \$1,540)	31,283	25,371
<hr/>		
Total cash, cash equivalents, and short-term investments	36,788	31,447
Accounts receivable, net of allowance for doubtful accounts of \$375 and \$451	13,014	11,192
Inventories	740	717
Deferred income taxes	2,184	2,213
Other	2,950	3,711
<hr/>		
Total current assets	55,676	49,280
Property and equipment, net of accumulated depreciation of \$8,629 and \$7,547	7,630	7,535
Equity and other investments	7,754	4,933
Goodwill	12,394	12,503
Intangible assets, net	1,158	1,759
Deferred income taxes	0	279
Other long-term assets	1,501	1,599
<hr/>		
Total assets	\$ 86,113	\$ 77,888
<hr/>		
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Accounts payable	\$ 4,025	\$ 3,324
Short-term debt	1,000	2,000
Accrued compensation	3,283	3,156
Income taxes	1,074	725
Short-term unearned revenue	13,652	13,003
Securities lending payable	182	1,684
Other	2,931	3,142
<hr/>		
Total current liabilities	26,147	27,034
Long-term debt	4,939	3,746
Long-term unearned revenue	1,178	1,281
Deferred income taxes	229	0
Other long-term liabilities	7,445	6,269
Commitments and contingencies		
Stockholders equity:		

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Common stock and paid-in capital	shares authorized 24,000; outstanding <b>8,668</b> and 8,908	<b>62,856</b>	62,382
Retained deficit, including accumulated other comprehensive income of <b>\$1,055</b> and \$969		<b>(16,681)</b>	(22,824)
<hr/>			
Total stockholders' equity		<b>46,175</b>	39,558
<hr/>			
Total liabilities and stockholders' equity		<b>\$ 86,113</b>	\$ 77,888
		<hr/>	<hr/>

See accompanying notes.

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**CASH FLOWS STATEMENTS**

(In millions)

Year Ended June 30,	2010	2009	2008
<b>Operations</b>			
Net income	\$ 18,760	\$ 14,569	\$ 17,681
Adjustments to reconcile net income to net cash from operations:			
Depreciation, amortization, and other noncash items	2,673	2,562	2,056
Stock-based compensation	1,891	1,708	1,479
Net recognized losses (gains) on investments and derivatives	(208)	683	(572)
Excess tax benefits from stock-based compensation	(45)	(52)	(120)
Deferred income taxes	(220)	762	935
Deferral of unearned revenue	29,374	24,409	24,532
Recognition of unearned revenue	(28,813)	(25,426)	(21,944)
Changes in operating assets and liabilities:			
Accounts receivable	(2,238)	2,215	(1,569)
Other current assets	420	(422)	153
Other long-term assets	(223)	(273)	(98)
Other current liabilities	1,295	(3,371)	(748)
Other long-term liabilities	1,407	1,673	(173)
<b>Net cash from operations</b>	<b>24,073</b>	<b>19,037</b>	<b>21,612</b>
<b>Financing</b>			
Short-term borrowings (repayments), maturities of 90 days or less, net	(991)	1,178	0
Proceeds from issuance of debt, maturities longer than 90 days	4,167	4,796	0
Repayments of debt, maturities longer than 90 days	(2,986)	(228)	0
Common stock issued	2,311	579	3,494
Common stock repurchased	(11,269)	(9,353)	(12,533)
Common stock cash dividends paid	(4,578)	(4,468)	(4,015)
Excess tax benefits from stock-based compensation	45	52	120
Other	10	(19)	0
<b>Net cash used in financing</b>	<b>(13,291)</b>	<b>(7,463)</b>	<b>(12,934)</b>
<b>Investing</b>			
Additions to property and equipment	(1,977)	(3,119)	(3,182)
Acquisition of companies, net of cash acquired	(245)	(868)	(8,053)
Purchases of investments	(30,168)	(36,850)	(20,954)
Maturities of investments	7,453	6,191	2,597
Sales of investments	15,125	19,806	25,132
Securities lending payable	(1,502)	(930)	(127)

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Net cash used in investing	<b>(11,314)</b>	(15,770)	(4,587)
Effect of exchange rates on cash and cash equivalents	<b>(39)</b>	(67)	137
Net change in cash and cash equivalents	<b>(571)</b>	(4,263)	4,228
Cash and cash equivalents, beginning of period	<b>6,076</b>	10,339	6,111
Cash and cash equivalents, end of period	<b>\$ 5,505</b>	\$ 6,076	\$ 10,339

See accompanying notes.

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**STOCKHOLDERS EQUITY STATEMENTS**

(In millions)

Year Ended June 30,	2010	2009	2008
<b>Common stock and paid-in capital</b>			
Balance, beginning of period	\$ 62,382	\$ 62,849	\$ 60,557
Common stock issued	2,311	567	3,504
Common stock repurchased	(3,113)	(2,611)	(3,022)
Stock-based compensation expense	1,891	1,708	1,479
Stock-based compensation income tax benefits (deficiencies)	(647)	(128)	253
Other, net	32	(3)	78
<b>Balance, end of period</b>	<b>62,856</b>	<b>62,382</b>	<b>62,849</b>
<b>Retained deficit</b>			
Balance, beginning of period	(22,824)	(26,563)	(29,460)
Cumulative effect of a change in accounting principle relating to uncertain tax positions	0	0	(395)
Cumulative effect of a change in accounting principle relating to costs of certain compensated absences	0	0	(17)
Net income	18,760	14,569	17,681
Other comprehensive income:			
Net unrealized gains on derivatives	27	302	18
Net unrealized gains (losses) on investments	265	(233)	(653)
Translation adjustments and other	(206)	(240)	121
<b>Comprehensive income</b>	<b>18,846</b>	<b>14,398</b>	<b>17,167</b>
Common stock cash dividends	(4,547)	(4,620)	(4,084)
Common stock repurchased	(8,156)	(6,039)	(9,774)
<b>Balance, end of period</b>	<b>(16,681)</b>	<b>(22,824)</b>	<b>(26,563)</b>
<b>Total stockholders equity</b>	<b>\$ 46,175</b>	<b>\$ 39,558</b>	<b>\$ 36,286</b>

See accompanying notes.

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**NOTES TO FINANCIAL STATEMENTS**

**NOTE 1 ACCOUNTING POLICIES**

**Accounting Principles**

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America.

**Principles of Consolidation**

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

**Estimates and Assumptions**

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

**Foreign Currencies**

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

**Revenue Recognition**

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable.

Revenue for retail packaged products, products licensed to original equipment manufacturers (OEMs), and perpetual licenses under certain volume licensing programs generally is recognized as products are shipped or made available. A portion of the revenue related to Windows XP is deferred due to the right to receive unspecified upgrades/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. The amount of revenue allocated to the unspecified upgrade/enhancement rights for Microsoft Internet Explorer is based on the vendor-specific objective evidence of fair value for those elements using the residual method or relative fair value method and the deferred revenue is recognized ratably on a straight-line basis over the Windows XP life cycle. Revenue related to Windows Vista and Windows 7 is not subject to a similar deferral because there are no significant undelivered elements. Revenue for products under the technology guarantee programs, which provide free or significantly discounted rights to use upcoming new versions of a software product if an end user licenses existing versions of the product

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during the eligibility period, is allocated between existing product and the new product, and revenue allocated to the new product is deferred until that version is delivered. The revenue allocation is based on vendor-specific objective evidence of fair value of both products.



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Certain multi-year licensing arrangements include a perpetual license for current products combined with rights to receive future versions of software products on a when-and-if-available basis ( Software Assurance ) and are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the billing coverage period. Revenue from certain arrangements that allow for the use of a product or service over a period of time without taking possession of software are also accounted for as subscriptions.

Revenue related to our Xbox 360 gaming and entertainment console, games published by us, and other hardware components is generally recognized when ownership is transferred to the retailers. Revenue related to games published by third parties for use on the Xbox 360 platform is recognized when games are manufactured by the game publishers. Display advertising revenue is recognized as advertisements are displayed. Search advertising revenue is recognized when the ad appears in the search results or when the action necessary to earn the revenue has been completed. Consulting services revenue is recognized as services are rendered, generally based on the negotiated hourly rate in the consulting arrangement and the number of hours worked during the period. Consulting revenue for fixed-price services arrangements is recognized as services are provided.

Revenue generally is recognized net of any taxes collected from customers and subsequently remitted to governmental authorities.

**Cost of Revenue**

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

**Product Warranty**

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

**Research and Development**

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Such costs related to software development are included in research and development expense until the point that technological feasibility is reached, which for our software products, is generally shortly before the products are released to manufacturing. Once technological feasibility is reached, such costs are capitalized and amortized to cost of revenue over the estimated lives of the products.

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#### **Sales and Marketing**

Sales and marketing expenses include payroll, employee benefits, stock-based compensation, and other headcount-related expenses associated with sales and marketing personnel, and the costs of advertising, promotions, trade shows, seminars, and other programs. Advertising costs are expensed as incurred. Advertising expense was \$1.6 billion, \$1.4 billion, and \$1.2 billion in fiscal years 2010, 2009, and 2008, respectively.

#### **Employee Severance**

We record employee severance when a specific plan has been approved by management, the plan has been communicated to employees, and it is unlikely that significant changes will be made to the plan.

#### **Stock-Based Compensation**

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

#### **Employee Stock Purchase Plan**

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

#### **Income Taxes**

Income tax expense includes U.S. and international income taxes, the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested and interest and penalties on uncertain tax positions. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes.

#### **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

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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

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applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and forward and spot prices for currencies and commodities. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, mortgage-backed securities, agency securities, certificates of deposit, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.

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

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

Our current financial liabilities, including our short-term debt, have fair values that approximate their carrying values. Our long-term financial liabilities consist of long-term debt which is recorded on the balance sheet at issuance price less unamortized discount.

**Financial Instruments**

We consider all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. The fair values of these investments approximate their carrying values. In general, investments with original maturities of greater than three months and remaining maturities of less than one year are classified as short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash equivalents and short-term investments are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in market value, excluding other-than-temporary impairments, are reflected in OCI.

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

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

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. Fair value is calculated based on publicly available market information or other estimates determined by management. We employ a systematic methodology on a quarterly basis that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell,



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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.

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

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

For derivative instruments designated as cash-flow hedges, the effective portion of the derivative's gain (loss) is initially reported as a component of 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).

**Allowance for Doubtful Accounts**

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

(In millions)

Year Ended June 30,	2010	2009	2008
Balance, beginning of period	\$ 451	\$ 153	\$ 117
Charged to costs and other	45	360	88
Write-offs	(121)	(62)	(52)
Balance, end of period	\$ 375	\$ 451	\$ 153

**Inventories**

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Inventories are stated at the lower of cost or market, using the average cost method. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue.

