

MICROSOFT CORP
Form 10-K
August 02, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended June 30, 2017

OR

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

For the Transition Period From to

Commission File Number 001-37845

MICROSOFT CORPORATION

WASHINGTON 91-1144442
(STATE OF INCORPORATION) (I.R.S. ID)

ONE MICROSOFT WAY, REDMOND, WASHINGTON 98052-6399

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

COMMON STOCK, \$0.00000625 par value per share

NASDAQ

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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 website, 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Emerging growth company

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

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

As of December 31, 2016, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$466.5 billion based on the closing sale price as reported on the NASDAQ National Market System. As of July 31, 2017, there were 7,702,243,979 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 29, 2017 are incorporated by reference into Part III.

MICROSOFT CORPORATION

FORM 10-K

For the Fiscal Year Ended June 30, 2017

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Note About Forward-Looking Statements

This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: “Business” (Part I, Item 1 of this Form 10-K), “Risk Factors” (Part I, Item 1A of this Form 10-K), and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (Part II, Item 7 of this Form 10-K). These forward-looking statements generally are identified by the words “believe,” “project,” “expect,” “anticipate,” “estimate,” “intend,” “strategy,” “opportunity,” “plan,” “may,” “should,” “will,” “would,” “will be,” “will continue,” “will likely result,” and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in “Risk Factors,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and “Quantitative and Qualitative Disclosures about Market Risk” (Part II, Item 7A of this Form 10-K). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

PART I

ITEM 1. BUSINESS

GENERAL

Our vision

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our strategy is to build best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence (“AI”).

The way individuals and organizations use and interact with technology continues to evolve. A person’s experience with technology increasingly spans a multitude of devices and becomes more natural and multi-sensory with voice, ink, and gaze interactions. We believe a new technology paradigm is emerging that manifests itself through an intelligent cloud and an intelligent edge where computing is more distributed, AI drives insights and acts on the user’s behalf, and user experiences span devices with a user’s available data and information. We continue to transform our business to lead this new era of digital transformation and enable our customers and partners to thrive in this evolving world.

What we offer

Founded in 1975, we operate worldwide in over 190 countries. We develop, license, and support a wide range of software products, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people’s lives. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

Our products include operating systems; cross-device productivity applications; server applications; business solution applications; desktop and server management tools; software development tools; video games; and training and certification of computer system integrators and developers. We also design, manufacture, and sell devices, including PCs, tablets, gaming and entertainment consoles, other intelligent devices, and related accessories, that integrate with our cloud-based offerings. We offer an array of services, including cloud-based solutions that provide customers with software, services, platforms, and content, and we provide solution support and consulting services. We also deliver relevant online advertising to a global audience.

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The ambitions that drive us

To achieve our vision, our research and development efforts focus on three interconnected ambitions:

• Reinvent productivity and business processes.

• Build the intelligent cloud platform.

• Create more personal computing.

Reinvent productivity and business processes

We believe we can significantly enhance the lives of our customers using our broad portfolio of productivity, communication, and information products and services that span platforms and devices. Productivity is our first and foremost objective, to enable people to meet and collaborate more easily, and to effectively express ideas in new ways. We invent new scenarios that in turn create opportunity for our partners and help businesses accelerate their digital transformation while respecting each person's privacy choices.

The foundation for these efforts rests on advancing our leading productivity, collaboration, communication, and business process tools including Microsoft Office, Microsoft Dynamics, and LinkedIn. With Office 365, we provide familiar industry-leading productivity and business process tools as cloud services, enabling access from anywhere and any device. New scenarios – like those enabled by Microsoft Teams – will redefine how work gets done and help foster employee engagement and culture. This work creates an opportunity to reach new customers and expand the usage of our services by our existing customers. We see opportunity in combining our offerings in new ways that are mobile, secure, collaborative, intelligent, and trustworthy. We offer our services across platforms and devices outside our own. As people move from device to device, so does their content and the richness of their services. We engineer our applications so users can find, try, and buy them in friction-free ways.

On December 8, 2016, we completed our acquisition of LinkedIn Corporation, the world's largest professional network on the Internet. The acquisition is expected to accelerate the growth of Office 365, Dynamics 365, and LinkedIn.

Build the intelligent cloud platform

Cloud computing is foundational to enabling any organization's digital transformation. In deploying technology that advances business strategy, enterprises decide what solutions will make employees more productive, collaborative, and satisfied, and connect with customers in new and compelling ways. Enterprises work to unlock business insights from a world of data. To achieve these objectives, they increasingly look to leverage the benefits of the cloud. Helping businesses digitally transform and move to the cloud is one of our largest opportunities. As one of the two largest providers of cloud computing at scale, we believe we work from a position of strength. The Microsoft Cloud is a secure solution that can listen, learn, and predict; turning data into actionable insight that enhances business opportunities. It provides a scalable and complete collaboration suite that transforms the way teams work. With the cloud, high-performance computing and agility can help businesses expand their growth.

Our cloud business benefits from three economies of scale: larger datacenters that deploy computational resources at significantly lower cost per unit than smaller ones; larger datacenters that coordinate and aggregate diverse customer, geographic, and application demand patterns, improving the utilization of computing, storage, and network resources; and multi-tenancy locations that lower application maintenance labor costs.

We believe our server products and cloud services, which include Microsoft SQL Server, Windows Server, Visual Studio, System Center, and Microsoft Azure, make us the only company with a public, private, and hybrid cloud platform that can power modern business. What differentiates Azure is our hybrid consistency, developer productivity, and software-as-a-service (“SaaS”) application integration. In addition, our hybrid infrastructure spans identity, data, compute, management, and security, helping to support the real-world needs and evolving regulatory requirements of commercial customers and enterprise-focused SaaS partners. We are working to enhance the customer’s return on investment by enabling enterprises to combine their existing datacenters and our public cloud into a single cohesive infrastructure. Businesses can deploy applications in their own datacenter, a partner’s datacenter, or in our datacenters with common security, management, and administration across all environments, providing the flexibility and scale they want. AI will be pervasive across devices, applications, and infrastructure to drive insights and act on the user’s behalf. Azure is also unique in its support for emerging applications so that Internet of Things (“IoT”) devices can act locally at the edge while taking advantage of the cloud for global coordination and machine learning at scale.

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

Create more personal computing

We strive to make computing more personal by putting users at the core of the experience, enabling them to interact with technology in more intuitive, engaging, and dynamic ways. Windows 10 is the cornerstone of our ambition to create more personal computing, allowing us to move from an operating system that runs on a PC to a service that can power the full spectrum of devices. Windows 10 is more personal and productive with functionality such as Cortana, Windows Hello, Windows Ink, Microsoft Edge, and universal applications. Windows 10 offers a foundation for the secure, modern workplace. Windows 10 is designed to foster innovation – from us, our partners, and developers – through rich and consistent experiences across the range of existing devices and entirely new device categories.

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

With the unified Windows operating system, developers and OEMs can contribute to a thriving Windows ecosystem. We invest heavily to make Windows the most secure, manageable, and capable operating system for the needs of a modern workforce. We are working to create a broad developer opportunity by unifying the Windows installed base on Windows 10, and by enabling universal Windows applications to run across all device targets.

As part of our strategic objectives, we are committed to designing and marketing first-party devices to help drive innovation, create new categories, and stimulate demand in the Windows ecosystem. We are developing new input and output methods within Windows 10, including speech, pen, gesture, and mixed reality capabilities to power more personal computing experiences. The experiences and tools we build will unlock the creator in everyone and enable seamless teamwork not just in the workplace, but also at school and at home across all the devices people use.

Our future opportunity

Customers are looking to Microsoft and our thriving partner ecosystem to accelerate their own digital transformations and to unlock new opportunity in this era of intelligent cloud and intelligent edge. We continue to develop complete, intelligent solutions for our customers, including offerings like the recently introduced Microsoft 365 which brings together Office 365, Windows 10, and Enterprise Mobility and Security, that empower users to be creative and work together while safeguarding businesses and simplifying IT management. Our goal is to lead the industry in several distinct areas of technology over the long-term, which we expect will translate to sustained growth. We are investing

significant resources in:

- Transforming the workplace to deliver new modular business applications to improve how people communicate, collaborate, learn, work, play, and interact with one another.
- Building and running cloud-based services in ways that unleash new experiences and opportunities for businesses and individuals, including converting data into AI.
- Using Windows to develop new categories of devices – both our own and third-party – as a person’s experience with technology becomes more natural, personal, and predictive with multi-sensory breakthroughs in voice, ink, gaze interactions, and augmented reality holograms.

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• Inventing new gaming experiences that bring people together around their shared love for games, using an approach that enables people to play the games they want, with the people they want, on the devices they want.

• Applying AI to drive insights and act on our customer's behalf by understanding and interpreting their needs using natural methods of communication.

Our future growth depends on our ability to transcend current product category definitions, business models, and sales motions. We have the opportunity to redefine what customers and partners can expect and are working to deliver new solutions that reflect the best of Microsoft.

OPERATING SEGMENTS

We operate our business and report our financial performance using three segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. 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 resources within businesses.

Additional information on our operating segments and geographic and product information is contained in Note 21 – Segment Information and Geographic Data of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

Our reportable segments are described below.

Productivity and Business Processes

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

• Office Commercial, including Office 365 subscriptions and Office licensed on-premises, comprising Office, Exchange, SharePoint, Skype for Business, and Microsoft Teams, and related Client Access Licenses (“CALs”).

• Office Consumer, including Office 365 subscriptions and Office licensed on-premises, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.

• LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.

• Dynamics business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.

Office Commercial

Office Commercial is designed to increase personal, team, and organizational productivity through a range of products and services. Growth depends on our ability to reach new users, add value to our core product set, and continue to expand our product and service offerings into new markets such as security, analytics, collaboration, unified communications, and business intelligence. Office Commercial revenue is mainly affected by a combination of the demand from commercial customers for volume licensing, including Software Assurance, and the number of information workers in an enterprise, as well as the continued shift to Office 365. CALs provide certain Office Commercial products and services with access rights to our server products and CAL revenue is reported with the associated Office products and services.

Office Consumer

Office Consumer is designed to increase personal productivity through a range of products and services. Growth depends on our ability to reach new users, add value to our core product set, and continue to expand our product and service offerings into new markets. Office Consumer revenue is mainly affected by the percentage of customers that buy Office with their new devices and the continued shift to Office 365. Office Consumer Services revenue is mainly affected by the demand for communication and storage through Skype, Outlook.com, and OneDrive, which is largely driven by subscriptions, advertising, and the sale of minutes.

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LinkedIn

LinkedIn connects the world's professionals to make them more productive and successful, and is the world's largest professional network on the Internet. LinkedIn offers services that can be used by customers to transform the way they hire, market, sell, and learn. In addition to LinkedIn's free services, LinkedIn offers three categories of monetized solutions: Talent Solutions, Marketing Solutions, and Premium Subscriptions, which includes Sales Solutions. Talent Solutions is comprised of two elements: Hiring, and Learning and Development. Hiring provides services to recruiters that enable them to attract, recruit, and hire talent. Learning and Development provides subscriptions to enterprises and individuals to access online learning content. Marketing Solutions enables companies to advertise to LinkedIn's member base. Premium Subscriptions enables professionals to manage their professional identity, grow their network, and connect with talent through additional services like premium search. Premium Subscriptions also includes Sales Solutions, which helps sales professionals find, qualify, and create sales opportunities and accelerate social selling capabilities. Growth will depend on our ability to increase the number of LinkedIn members and our ability to continue offering services that provide value for our members and increase their engagement. LinkedIn revenue is mainly affected by demand from enterprises and professional organizations for subscriptions to Talent Solutions and Premium Subscriptions offerings, as well as member engagement and the quality of the sponsored content delivered to those members to drive Marketing Solutions.

Dynamics

Dynamics provides on-premises and cloud-based business solutions for financial management, enterprise resource planning ("ERP"), customer relationship management ("CRM"), supply chain management, and analytics applications for small and medium businesses, large organizations, and divisions of global enterprises. Dynamics revenue is largely driven by the number of information workers licensed and the continued shift to Dynamics 365, a unified set of cloud-based intelligent business applications for enterprises.

Competition

Competitors to Office include software and global application vendors such as Adobe Systems, Apple, Cisco Systems, Facebook, Google, IBM, Oracle, SAP, and numerous web-based and mobile application competitors as well as local application developers in Asia and Europe. Cisco Systems is using its position in enterprise communications equipment to grow its unified communications business. Google provides a hosted messaging and productivity suite. Apple distributes versions of its pre-installed application software, such as email and calendar products, through its PCs, tablets, and phones. Skype for Business and Skype also compete with a variety of instant messaging, voice, and video communication providers, ranging from start-ups to established enterprises. Web-based offerings competing with individual applications have also positioned themselves as alternatives to our products. We believe our products compete effectively based on our strategy of providing powerful, flexible, secure, and easy-to-use solutions that work well with technologies our customers already have and are available on a device or via the cloud.

LinkedIn faces competition from online recruiting companies, talent management companies, and larger companies that are focusing on talent management and human resource services; job boards; traditional recruiting firms; and companies that provide learning and development products and services. Marketing Solutions competes with online and offline outlets that generate revenue from advertisers and marketers.

Dynamics competes with vendors such as Oracle and SAP in the market that provides solutions for large organizations and divisions of global enterprises. In the market that provides solutions for small and mid-sized businesses, our Dynamics products compete with vendors such as Infor, The Sage Group, and NetSuite. Salesforce.com's cloud CRM offerings compete with our Dynamics CRM on-premises and Dynamics 365 offerings.

Intelligent Cloud

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

- Server products and cloud services, including Microsoft SQL Server, Windows Server, Visual Studio, System Center, and related CALs, and Azure.

- Enterprise Services, including Premier Support Services and Microsoft Consulting Services.

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Server Products and Cloud Services

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

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

Enterprise Services

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

Competition

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

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

Our database, business intelligence, and data warehousing solutions offerings compete with products from IBM, Oracle, SAP, and other companies. Our system management solutions compete with server management and server

virtualization platform providers, such as BMC, CA Technologies, Hewlett-Packard, IBM, and VMware. Our products for software developers compete against offerings from Adobe, IBM, Oracle, and other companies, and also against open-source projects, including Eclipse (sponsored by CA Technologies, IBM, Oracle, and SAP), PHP, and Ruby on Rails.

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

Azure faces diverse competition from companies such as Amazon, Google, IBM, Oracle, Salesforce.com, VMware, and open source offerings. Azure's competitive advantage includes enabling a hybrid cloud, allowing deployment of existing datacenters with our public cloud into a single, cohesive infrastructure, and the ability to run at a scale that meets the needs of businesses of all sizes and complexities.

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

More Personal Computing

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

• Windows, including Windows OEM licensing (“Windows OEM”) and other non-volume licensing of the Windows operating system; Windows Commercial, comprising volume licensing of the Windows operating system, Windows cloud services, and other Windows commercial offerings; patent licensing; Windows IoT; and MSN display advertising.

• Devices, including Microsoft Surface, PC accessories, and other intelligent devices.

• Gaming, including Xbox hardware and Xbox software and services, comprising Xbox Live transactions, subscriptions, and advertising (“Xbox Live”), video games, and third-party video game royalties.

• Search advertising.

Windows

The Windows operating system is designed to deliver a more personal computing experience for users by enabling consistency of experience, applications, and information across their devices. Windows OEM revenue is impacted significantly by the number of Windows operating system licenses purchased by OEMs, which they pre-install on the devices they sell. In addition to computing device market volume, Windows OEM revenue is impacted by:

• The mix of computing devices based on form factor and screen size.

- Differences in device market demand between developed markets and emerging markets.

• Attachment of Windows to devices shipped.

• Customer mix between consumer, small and medium businesses, and large enterprises.

• Changes in inventory levels in the OEM channel.

• Pricing changes and promotions, pricing variation that occurs when the mix of devices manufactured shifts from local and regional system builders to large multinational OEMs, and different pricing of Windows versions licensed.

• Piracy.

Windows Commercial revenue, which includes volume licensing of the Windows operating system, is affected mainly by the demand from commercial customers for volume licensing and Software Assurance, often reflecting the number of information workers in a licensed enterprise, and is therefore relatively independent of the number of PCs sold in a given year. Revenue from Windows cloud services, such as Windows Defender Advanced Threat Protection, and other Windows commercial offerings, is mainly impacted by attachment of Windows to devices shipped, pricing changes and promotions, mix of computing devices, and the customer mix among large enterprises, small and medium businesses, and educational institutions.

Patent licensing includes our programs to license patents we own for use across a broad array of technology areas, including mobile devices and cloud offerings.

Windows IoT extends the power of Windows and the cloud to intelligent systems by delivering specialized operating systems, tools, and services for use in embedded devices.

Display advertising primarily includes MSN ads. In June 2015, we entered into agreements with AOL and AppNexus to outsource our display sales responsibility.

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Devices

We design, manufacture, and sell devices, including Surface, PC accessories, and other intelligent devices, such as Surface Hub and HoloLens. Our devices are designed to enable people and organizations to connect to the people and content that matter most using Windows and integrated Microsoft products and services. Surface is designed to help organizations, students, and consumers be more productive. We released the Surface Studio in December 2016 and our latest Surface devices, the Surface Laptop and Surface Pro, in June 2017.

In July 2015, we announced a plan to restructure our phone business to better focus and align resources. In May 2016, we announced plans to further streamline our smartphone hardware business. In November 2016, we completed the sale of our feature phone business.

Gaming

Our gaming platform is designed to provide a unique variety of entertainment using our devices, peripherals, applications, online services, and content. We released Xbox One and Xbox One S in November 2013 and August 2016, respectively, and announced Xbox One X in June 2017. With the launch of the Windows 10 Xbox app in July 2015, and the launch of the Mixer service in May 2017, we continue to open new opportunities for customers to engage both on- and off-console. Xbox Live enables people to connect and share online gaming experiences and is accessible on Xbox consoles, Windows-enabled devices, and other devices. Xbox Live is designed to benefit users by providing access to a network of certified applications and services and to benefit our developer and partner ecosystems by providing access to a large customer base. Xbox Live revenue is mainly affected by subscriptions and sales of Xbox Live enabled content, as well as advertising. We also design and sell gaming content to showcase our unique platform capabilities for Xbox consoles, Windows-enabled devices, and other devices. Growth of our gaming business is determined by the overall active user base through Xbox Live enabled content, availability of games, providing exclusive game content that gamers seek, the computational power and reliability of the devices used to access our content and services, and the ability to create new experiences via online services, downloadable content, and peripherals.

Search Advertising

Search advertising, including Bing and Bing Ads, is designed to deliver relevant online advertising to a global audience. We have several partnerships with other companies, including Oath (formerly Yahoo! and AOL) which is owned by Verizon, through which we provide and monetize search queries. Growth depends on our ability to attract new users, understand intent, and match intent with relevant content and advertiser offerings.

Competition

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

Devices face competition from various computer, tablet, hardware, and phone manufacturers who offer a unique combination of high-quality industrial design and innovative technologies across various price points. These

manufacturers, many of which are also current or potential partners and customers, include Apple and our Windows OEMs.

Our gaming platform competes with console platforms from Sony and Nintendo, both of which have a large, established base of customers. The lifecycle for gaming and entertainment consoles averages five to ten years. Nintendo released its latest generation console in March 2017 and Sony released its latest generation console in November 2013. We also compete with other providers of entertainment services through online marketplaces. We believe our gaming platform is effectively positioned against competitive products and services based on significant innovation in hardware architecture, user interface, developer tools, online gaming and entertainment services, and continued strong exclusive content from our own game franchises as well as other digital content offerings. Our video games competitors include Electronic Arts and Activision Blizzard. Xbox Live faces competition from various online marketplaces, including those operated by Amazon, Apple, and Google.

Our search advertising business competes with Google and a wide array of websites, social platforms like Facebook, and portals that provide content and online offerings to end users.

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OPERATIONS

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

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

Our devices are primarily manufactured by third-party contract manufacturers. We generally have the ability to use other manufacturers if a current vendor becomes unavailable or unable to meet our requirements.

We sold our feature phone business in November 2016, which included the sale of our phone manufacturing facility in Vietnam.

RESEARCH AND DEVELOPMENT

During fiscal years 2017, 2016, and 2015, research and development expense was \$13.0 billion, \$12.0 billion, and \$12.0 billion, respectively. These amounts represented 14%, 14%, and 13% of revenue in fiscal years 2017, 2016, and 2015, respectively. We plan to continue to make significant investments in a broad range of research and development efforts.

Product and Service Development, and Intellectual Property

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

• **Office Product Group**, focuses on our business across productivity, communications, education, and other information applications and services.

- **Artificial Intelligence and Research**, focuses on our AI development and other forward-looking research and development efforts spanning infrastructure, services, applications, and search.

• **Cloud and Enterprise**, focuses on our cloud infrastructure, server, database, CRM, ERP, management and development tools, and other business process applications and services for enterprises.

• **Windows and Devices Group**, focuses on our Windows platform, applications, games, store, and devices that power the Windows ecosystem.

• **LinkedIn**, focuses on our services that transform the way customers hire, market, sell, and learn.

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

We protect our intellectual property investments in a variety of ways. We work actively in the U.S. and internationally to ensure the enforcement of copyright, trademark, trade secret, and other protections that apply to our software and hardware products, services, business plans, and branding. We are a leader among technology companies in pursuing patents and currently have a portfolio of over 66,000 U.S. and international patents issued and over 35,000 pending. While we employ much of our internally developed intellectual property exclusively in our products and services, we also engage in outbound and inbound licensing of specific patented technologies that are incorporated into licensees' or Microsoft's products. From time to time, we enter into broader cross-license agreements with other technology companies covering entire groups of patents. We also purchase or license technology that we incorporate into our products and services. At times, we make select intellectual property broadly available at no or low cost to achieve a strategic objective, such as promoting industry standards, advancing interoperability, or attracting and enabling our external development community.

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

Investing in the Future

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

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

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

DISTRIBUTION, SALES, AND MARKETING

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

OEMs

We distribute our software through OEMs that pre-install our software on new devices and servers they sell. The largest component of the OEM business is the Windows operating system pre-installed on devices. OEMs also sell devices pre-installed with other Microsoft products and services, including applications such as Office and the capability to subscribe to Office 365.

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

Direct

Many organizations that license our products and services transact directly with us through Enterprise Agreements and Enterprise Services contracts, with sales support from system integrators, independent software vendors, web agencies, and partners that advise organizations on licensing our products and services (“Enterprise Agreement Software Advisors”, or “ESA”). Microsoft offers direct sales programs targeted to reach small, medium, and corporate customers, in addition to those offered through the reseller channel. A large network of partner advisors support many of these sales.

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We also provide commercial and consumer products and services directly to customers, such as cloud services, search, and gaming, through our online portals, marketplaces, and retail stores.

Distributors and Resellers

Organizations also license our products and services indirectly, primarily through licensing solution partners (“LSP”), distributors, value-added resellers (“VAR”), OEMs, and retailers. Although each type of reselling partner may reach organizations of all sizes, LSPs are primarily engaged with large organizations, distributors resell primarily to VARs, and VARs typically reach small and medium organizations. ESAs are also typically authorized as LSPs and operate as resellers for our other volume licensing programs. Microsoft Cloud Solution Provider is our main partner program for reselling cloud services.

Our Dynamics software offerings are also licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services. We distribute our retail packaged products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets. Individual consumers obtain these products primarily through retail outlets. We distribute our devices through third-party retailers. We have a network of field sales representatives and field support personnel that solicit orders from distributors and resellers, and provide product training and sales support.

LICENSING OPTIONS

We offer options for organizations that want to purchase our cloud services, on-premises software, and Software Assurance. We license software to organizations under volume licensing agreements to allow the customer to acquire multiple licenses of products and services instead of having to acquire separate licenses through retail channels. We use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include those discussed below.

Software Assurance conveys rights to new software and upgrades for perpetual licenses released over the contract period. It also provides support, tools, and training to help customers deploy and use software efficiently. Software Assurance is included with certain volume licensing agreements and is an optional purchase with others.

Volume Licensing Programs

Enterprise Agreement

Enterprise Agreements offer large organizations a manageable volume licensing program that gives them the flexibility to buy cloud services and software licenses under one agreement. Enterprise Agreements are designed for medium or large organizations that want to license cloud services and on-premises software organization-wide over a three-year period. Organizations can elect to purchase perpetual licenses or subscribe to licenses. Software Assurance is included.

Microsoft Product and Services Agreement

MPSAs are designed for medium and large organizations that want to license cloud services and on-premises software as needed, with no organization-wide commitment, under a single, non-expiring agreement. Organizations purchase

perpetual licenses or subscribe to licenses. Software Assurance is optional for customers that purchase perpetual licenses.

Open

Open Licensing agreements are a simple, cost-effective way to acquire the latest Microsoft technology. Open Licensing agreements are designed for small and medium organizations that want to license cloud services and on-premises software over a one- to three-year period. Under the Open License program, organizations purchase perpetual licenses and Software Assurance is optional. Under Open Value programs, organizations can elect to purchase perpetual licenses or subscribe to licenses and Software Assurance is included.

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Select Plus

Select Plus agreements are designed for government and academic organizations to acquire on-premises licenses at any affiliate or department level, while realizing advantages as one organization. Organizations purchase perpetual licenses and Software Assurance is optional.

In July 2014, we announced the retirement over a two-year period of Select Plus agreements for commercial organizations. Beginning July 2015, no new Select Plus agreements were signed with commercial organizations. Starting in July 2016, we no longer accept orders from commercial organizations for Select Plus after their next agreement anniversary.

Microsoft Online Subscription Agreement

Microsoft Online Subscription Agreement is designed for small and medium organizations that want to subscribe to, activate, provision, and maintain cloud services seamlessly and directly via the web, through the Microsoft Online Subscription Program. The program allows customers to acquire monthly or annual subscriptions for cloud-based services.

Partner Programs

The Microsoft Cloud Solution Provider program offers customers an easy way to license the cloud services they need in combination with the value-added services offered by their systems integrator, hosting partner, or cloud reseller partner. Partners in this program can easily package their own products and services to directly provision, manage, and support their customer subscriptions.

The Microsoft Services Provider License Agreement allows service providers and independent software vendors who want to license eligible Microsoft software products to provide software services and hosted applications to their end customers. Partners license software over a three-year period and are billed monthly based on consumption.

The Independent Software Vendor Royalty program enables partners to integrate Microsoft products into other applications and then license the unified business solution to their end users.

CUSTOMERS

Our customers include individual consumers, small and medium organizations, large global enterprises, public-sector institutions, Internet service providers, application developers, and OEMs. No sales to an individual customer accounted for more than 10% of revenue in fiscal years 2017, 2016, or 2015. 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 August 2, 2017 were as follows:

Name	Age	Position with the Company
Satya Nadella	49	Chief Executive Officer
Christopher C. Capossela	47	Executive Vice President, Marketing and Consumer Business, and Chief Marketing Officer
Jean-Philippe Courtois	56	Executive Vice President and President, Microsoft Global Sales, Marketing and Operations
Kathleen T. Hogan	51	Executive Vice President, Human Resources
Amy E. Hood	45	Executive Vice President, Chief Financial Officer
Margaret L. Johnson	55	Executive Vice President, Business Development
Bradford L. Smith	58	President and Chief Legal Officer

Mr. Nadella was appointed Chief Executive Officer in February 2014. He served as Executive Vice President, Cloud and Enterprise from July 2013 until that time. From 2011 to 2013, Mr. Nadella served as President, Server and Tools. From 2009 to 2011, he was Senior Vice President, Online Services Division. From 2008 to 2009, he was Senior Vice President, Search, Portal, and Advertising. Since joining Microsoft in 1992, Mr. Nadella's roles also included Vice President of the Business Division. Mr. Nadella also serves on the Board of Directors of Starbucks Corporation.

Mr. Capossela was appointed Executive Vice President, Marketing and Consumer Business, and Chief Marketing Officer in July 2016. He had served as Executive Vice President, Chief Marketing Officer since March 2014. Previously, he served as the worldwide leader of the Consumer Channels Group, responsible for sales and marketing activities with OEMs, operators, and retail partners. In his more than 25 years at Microsoft, Mr. Capossela has held a variety of marketing leadership roles in the Microsoft Office Division. He was responsible for marketing productivity solutions including Microsoft Office, Office 365, SharePoint, Exchange, Skype for Business, Project, and Visio.

Mr. Courtois was named Executive Vice President and President, Microsoft Global Sales, Marketing and Operations in July 2016. Before that he was President of Microsoft International since 2005. He was Chief Executive Officer, Microsoft Europe, Middle East, and Africa from 2003 to 2005. He was Senior Vice President and President, Microsoft Europe, Middle East, and Africa from 2000 to 2003. He was Corporate Vice President, Worldwide Customer Marketing from 1998 to 2000. Mr. Courtois joined Microsoft in 1984.

Ms. Hogan was appointed Executive Vice President, Human Resources in November 2014. Prior to that Ms. Hogan was Corporate Vice President of Microsoft Services. She also served as Corporate Vice President of Customer Service and Support. Ms. Hogan joined Microsoft in 2003.

Ms. Hood was appointed Executive Vice President and Chief Financial Officer in July 2013, subsequent to her appointment as Chief Financial Officer in May 2013. From 2010 to 2013, Ms. Hood was Chief Financial Officer of the Microsoft Business Division. From 2006 through 2009, Ms. Hood was General Manager, Microsoft Business

Division Strategy. Since joining Microsoft in 2002, Ms. Hood has also held finance-related positions in the Server and Tools Business and the corporate finance organization.

Ms. Johnson was appointed Executive Vice President, Business Development in September 2014. Prior to that Ms. Johnson spent 24 years at Qualcomm in various leadership positions across engineering, sales, marketing and business development. She most recently served as Executive Vice President of Qualcomm Technologies, Inc. Ms. Johnson also serves on the Board of Directors of Live Nation Entertainment, Inc.

Mr. Smith was appointed President and Chief Legal Officer in September 2015. He served as Executive Vice President, General Counsel, and Secretary from 2011 to 2015, and served as Senior Vice President, General Counsel, and Secretary from 2001 to 2011. Mr. Smith was also named Chief Compliance Officer in 2002. Since joining Microsoft in 1993, he was Deputy General Counsel for Worldwide Sales and previously was responsible for managing the European Law and Corporate Affairs Group, based in Paris. Mr. Smith also serves on the Board of Directors of Netflix, Inc.

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EMPLOYEES

As of June 30, 2017, we employed approximately 124,000 people on a full-time basis, 73,000 in the U.S. and 51,000 internationally. Of the total employed people, 39,000 were in operations, including manufacturing, distribution, product support, and consulting services; 40,000 were in product research and development; 34,000 were in sales and marketing; and 11,000 were in general and administration. The acquisition of LinkedIn Corporation resulted in the addition of approximately 11,000 people in fiscal year 2017. Certain of our employees are subject to collective bargaining agreements.

AVAILABLE INFORMATION

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

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

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

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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.

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

Competition in the technology sector

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

Competition among platforms, ecosystems, and devices

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

• A competing vertically-integrated model, in which a single firm controls the software and hardware elements of a product and related services, has succeeded with some consumer products such as personal computers, tablets, phones, gaming consoles, and wearables. Competitors pursuing this model also earn revenue from services integrated with the hardware and software platform. We also offer some vertically-integrated hardware and software products and services. To the extent we shift a portion of our business to a vertically integrated model we increase our cost of revenue and reduce our operating margins.

• We derive substantial revenue from licenses of Windows operating systems on personal computers. We face significant competition from competing platforms developed for new devices and form factors such as smartphones and tablet computers. These devices compete on multiple bases including price and the perceived utility of the device and its platform. Users are increasingly turning to these devices to perform functions that in the past were performed by personal computers. Even if many users view these devices as complementary to a personal computer, the prevalence of these devices may make it more difficult to attract application developers to our PC operating system platforms. Competing with operating systems licensed at low or no cost may decrease our PC operating system margins. In addition, some of our devices compete with products made by our OEM partners, which may affect their commitment to our platform.

• Competing platforms have content and application marketplaces with scale and significant installed bases. The variety and utility of content and applications available on a platform are important to device purchasing decisions. Users sometimes incur costs to move data and buy new content and applications when switching platforms. To compete, we must successfully enlist developers to write applications for our marketplace and ensure that these

applications have high quality, customer appeal, and value. Efforts to compete with competitors' content and application marketplaces may increase our cost of revenue and lower our operating margins.

Business model competition

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

Even as we transition more of our business to a services and subscription business model, the license-based proprietary software model generates most of our software revenue. We bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from licensing our products. Many of our competitors also develop and sell software to businesses and consumers under this model.

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

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

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

Our increasing focus on services presents execution and competitive risks. A growing part of our business involves cloud-based services available across the spectrum of computing devices. Our strategic vision is to compete and grow by building best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with AI. At the same time, our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud and sometimes the user's choice of which suite of cloud-based services to use. We are devoting significant resources to develop and deploy our cloud-based strategies. The Windows ecosystem must continue to evolve with this changing environment. We are undertaking cultural and organizational changes to drive accountability and eliminate obstacles to innovation. The Company's investment in gaining insights from data is becoming central to the value of the services we deliver to customers, to our operational efficiency and key opportunities in monetization, customer perceptions of quality, and operational efficiency. Our ability to use data in this way may be constrained by regulatory developments that impede realizing the expected return from this investment.

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

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

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

We make significant investments in new products and services that may not achieve expected returns. We will continue to make significant investments in research, development, and marketing for existing products, services, and

technologies, including the Windows operating system, the Microsoft Office system, Bing, Windows Server, the Windows Store, the Microsoft Azure Services platform, Office 365, other cloud-based offerings, and the Xbox entertainment platform. We also invest in the development and acquisition of a variety of hardware for productivity, communication, and entertainment including PCs, tablets, gaming devices, and HoloLens. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software and hardware products or upgrades, unfavorably affecting revenue. We may not achieve significant revenue from new product, service, and

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distribution channel investments for several years, if at all. New products and services may not be profitable, and even if they are profitable, operating margins for some new products and businesses will not be as high as the margins we have experienced historically.

We did extensive preparation and ongoing compatibility testing for applications and devices to help ensure a positive experience for our users installing Windows 10. However, negative upgrade experiences could adversely affect the reception of Windows 10 in the marketplace and could lead to litigation or regulatory actions by customers and government agencies. In addition, we anticipate that Windows 10 will enable new post-license monetization opportunities beyond initial license revenues. Our inability to realize these opportunities to the extent we expect could have an adverse impact on our revenues. Finally, our practices for data collection, use, and management in Windows 10 are subject to regulatory review, and may result in decisions directing us to change these practices and imposing fines. If so, we could face negative public reaction, degraded user experiences, and reduced flexibility in product design.

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

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

If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings. We acquire other companies and intangible assets and may not realize all the economic benefit from those acquisitions, which could cause an impairment of goodwill or intangibles. We review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in our stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in industry segments in which we participate. We may be required to record a significant charge on our consolidated financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively affecting our results of operations. For example, in the fourth quarter of fiscal year 2015, we recorded a \$5.1 billion charge for the impairment of goodwill and a \$2.2 billion charge for the impairment of intangible assets, and in the fourth quarter of fiscal year 2016 we recorded a \$480 million charge for the impairment of intangible assets. The impairment charges for both periods related to our phone business. Our acquisition of LinkedIn resulted in a significant increase in our goodwill and intangible asset balances.

We may not earn the revenues we expect from our intellectual property rights.

We may not be able to adequately protect our intellectual property rights

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

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We may not receive expected royalties from our patent licenses

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

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

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

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

Security of Microsoft's information technology

Threats to IT security can take a variety of forms. Individual and groups of hackers and sophisticated organizations, including state-sponsored organizations or nation-states, continuously undertake attacks that pose threats to our customers and our IT. These actors may use a wide variety of methods, which may include developing and deploying malicious software to attack our products and services and gain access to our networks and datacenters, using social engineering techniques to induce our employees, users, partners, or customers to disclose passwords or other sensitive information or take other actions to gain access to our data or our users' or customers' data, or acting in a coordinated

manner to launch distributed denial of service or other coordinated attacks. Cyber threats are constantly evolving, increasing the difficulty of detecting and successfully defending against them. Cyber threats can have cascading impacts that unfold with increasing speed across our internal networks and systems and those of our partners and customers. Breaches of our network or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, result in product development delays, compromise confidential or technical business information harming our reputation or competitive position, result in theft or misuse of our intellectual property or other assets, require us to allocate more resources to improved technologies, or otherwise adversely affect our business.

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

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

The Security of our products and services is important in our customers' decisions to purchase or use our products or services. Security threats are a challenge to companies like us whose business is technology products and services. Threats to our own IT infrastructure can also affect our customers. Customers using our cloud-based services rely on the security of our infrastructure to ensure the reliability of our services and the protection of their data. Hackers tend to focus their efforts on the most popular operating systems, programs, and services, including many of ours, and we expect that to continue. Hackers that acquire user account information at other companies can use that information to compromise our users' accounts where accounts share the same attributes like passwords.

To defend against security threats, both to our internal IT systems and those of our customers, we must continuously engineer more secure products and services, enhance security and reliability features, improve the deployment of software updates to address security vulnerabilities, develop mitigation technologies that help to secure customers from attacks even when software updates are not deployed, maintain the digital security infrastructure that protects the integrity of our network, products, and services, and provide customers security tools such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. If we fail to do these things well, actual or perceived security vulnerabilities in our products and services could harm our reputation and lead customers to reduce or delay future purchases of products or subscriptions to services, or to use competing products or services. Customers may also spend more on protecting their existing computer systems from attack, which could delay adoption of additional products or services. Customers may fail to update their systems, continue to run software or operating systems we no longer support, or may fail timely to install security patches. Any of these actions by customers could adversely affect our revenue. Actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to liability, there is no assurance these provisions will withstand legal challenges. Legislative or regulatory action in these areas may increase the costs to develop, implement, or secure our products and services.

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

We may have outages, data losses, and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic, growth in services, and the complexity of our products and services demand more computing power. We spend substantial amounts to build, purchase, or lease datacenters and equipment and to upgrade our technology and network infrastructure to handle more traffic on our websites and in our datacenters. These demands continue to increase as we introduce new products and services and support the growth of existing services such as Bing, Exchange Online, Microsoft Azure, Microsoft Account services, Office 365, OneDrive, SharePoint Online, Skype, Xbox Live, Outlook.com, and Windows Stores. We are rapidly growing our business of providing a platform and back-end hosting for services provided by third parties to their end users. Maintaining, securing, and expanding this infrastructure is expensive and complex. It requires that we maintain an Internet connectivity infrastructure that is robust and reliable within competitive and regulatory constraints that continue to evolve. Inefficiencies or operational failures, including temporary or permanent loss of customer data or insufficient Internet connectivity, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, regulatory actions, damage to our reputation, and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

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

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

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

Government regulatory actions and court decisions such as these may hinder our ability to provide the benefits of our software to consumers and businesses, reducing the attractiveness of our products and the revenue that come from them. New competition law actions could be initiated. 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 precedent in other competition law proceedings.

- We are subject to a variety of ongoing commitments because of court or administrative orders, consent decrees, or other voluntary actions we have taken. If we fail to comply with these commitments, we may incur litigation costs and be subject to substantial fines or other remedial actions.

- Our ability to realize anticipated Windows 10 post-sale monetization opportunities may be limited.

Our global operations subject us to potential liability under anti-corruption, trade protection, and other laws and regulations. The Foreign Corrupt Practices Act and other anti-corruption laws and regulations (“Anti-Corruption Laws”)

prohibit corrupt payments by our employees, vendors, or agents. From time to time, we receive inquiries from authorities in the U.S. and elsewhere and reports from employees and others about our business activities outside the U.S. and our compliance with Anti-Corruption Laws. Specifically, we have been cooperating with authorities in the U.S. in connection with reports concerning our compliance with the Foreign Corrupt Practices Act in various countries. While we devote substantial resources to our global compliance programs and have implemented policies, training, and internal controls designed to reduce the risk of corrupt payments, our employees, vendors, or agents may violate our policies. Our failure to comply with Anti-Corruption Laws could result in significant fines and penalties, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation. Operations outside the U.S. may be affected by changes in trade protection laws, policies, and measures, sanctions, and other regulatory requirements affecting trade and investment. We may be subject to legal liability and reputational damage if we sell goods or services in violation of U.S. trade sanctions on countries such as Iran, North Korea, Cuba, Sudan, and Syria.

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

Laws and regulations relating to the handling of personal data may impede the adoption of our services or result in increased costs, legal claims, or fines against us. The growth of our Internet- and cloud-based services internationally relies increasingly on the movement of data across national boundaries. Legal requirements relating to the collection, storage, handling, and transfer of personal data continue to evolve. For example, the EU and the U.S. formally entered into a new framework in July 2016 that provides a mechanism for companies to transfer data from EU member states to the U.S. This new framework, called the Privacy Shield, is intended to address shortcomings identified by the European Court of Justice in a predecessor mechanism. The Privacy Shield and other mechanisms are subject to review by the European courts, which may lead to uncertainty about the legal basis for data transfers across the Atlantic. In 2016, the EU adopted a new law governing data practices and privacy called the General Data Protection Regulation ("GDPR"), which becomes effective in May 2018. The law requires firms to meet new requirements regarding the handling of personal data. Engineering efforts to build new capabilities to facilitate compliance with the law may entail substantial expense and the diversion of engineering resources from other projects. If we are unable to engineer products that meet Microsoft's legal duties or help our customers meet their obligations under the GDPR or other data regulations, we might experience reduced demand for our offerings. Non-compliance with the GDPR may result in monetary penalties of up to 4% of worldwide revenue.

Ongoing legal reviews by regulators may result in burdensome or inconsistent requirements affecting the location and movement of our customer and internal employee data as well as the management of that data. Compliance may require changes in services, business practices, or internal systems that result in increased costs, lower revenue, reduced efficiency, or greater difficulty in competing with foreign-based firms. Failure to comply with existing or new rules may result in significant penalties or orders to 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. Changes to U.S. immigration policies that restrain the flow of technical and professional talent may inhibit our ability to adequately staff our research and development efforts. If we are less successful in our recruiting efforts, or if we cannot retain 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. How employment-related laws are interpreted and applied to our workforce practices may result in increased operating costs and less flexibility in how we meet our workforce needs.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. These claims may arise from a wide variety of business practices and initiatives, including major new

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

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the 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 in different jurisdictions. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes favorably more difficult. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation in the jurisdictions where we are subject to taxation 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 consolidated financial statements in the period or periods in which that determination is made.

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

Our hardware and software products may experience quality or supply problems. Our vertically-integrated hardware products such as Xbox consoles, Surface devices, and other devices we design, manufacture, and market are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm as a result of recalls, safety alerts, or product liability claims if we fail to prevent, detect, or address such issues through design, testing, or warranty repairs. We acquire some device components from sole suppliers. Our competitors use some of the same suppliers and their demand for hardware components can affect the capacity available to us. If a component from a sole-source supplier is delayed or becomes unavailable, whether because of supplier capacity constraint or industry shortages, we may not obtain timely replacement supplies, resulting in reduced sales. Component shortages, excess or obsolete inventory, or price reductions resulting in inventory adjustments may increase our cost of revenue. Xbox consoles, Surface devices, and other hardware are assembled in Asia and other geographies that may be subject to disruptions in the supply chain, resulting in shortages that would affect our revenue and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

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

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

Our global business exposes us to operational and economic risks. Our customers are located in over 200 countries and a significant part of our revenue comes from international sales. The global nature of our business creates operational and economic risks. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents several risks, including deterioration of social, political, labor, or economic conditions in a country or region, and difficulties in staffing and managing foreign operations. Although we hedge a portion of our international currency exposure, significant fluctuations in foreign exchange rates between the U.S. dollar and foreign currencies may adversely affect our revenue. Competitive or regulatory pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the U.S. and other countries.

Catastrophic events or geopolitical conditions may disrupt our business. A disruption or failure of our systems or operations because of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other essential business

operations are in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are seismically active regions. A catastrophic event that results in the destruction or disruption of any of our critical business or IT systems could harm our ability to conduct normal business operations. Providing our customers with more services and solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged service outages on our operating results.

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Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may cause supply chain disruptions for hardware manufacturers. Geopolitical change may result in changing regulatory requirements that could impact our operating strategies, access to global markets, hiring, and profitability. Geopolitical instability may lead to sanctions and impact our ability to do business in some markets or with some public-sector customers. Emerging nationalist trends in specific countries may significantly alter the trade environment. Changes to trade policy or agreements may result in higher tariffs, local sourcing initiatives, or other developments that make it more difficult to sell our products in foreign countries. Any of these changes may negatively impact our revenues.

The long-term effects of climate change on the global economy or the IT industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy or other natural resources may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services.

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

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

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

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

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

could be adversely impacted.

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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 2017 that remain unresolved.

ITEM 2. PROPERTIES

Our corporate headquarters are located in Redmond, Washington. We have approximately 15 million square feet of space located in King County, Washington that is used for engineering, sales, marketing, and operations, among other general and administrative purposes. These facilities include approximately 10 million square feet of owned space situated on approximately 500 acres of land we own at our corporate headquarters, and approximately five million square feet of space we lease. In addition, we own and lease space domestically that includes office, retail, and datacenter space.

We also own and lease facilities internationally. Properties that we own include: our research and development centers in China and India; our operations in Ireland; and our facilities in Singapore, the Netherlands, and the United Kingdom. The largest leased properties include space in the following locations: India, China, the United Kingdom, Canada, France, Australia, Germany, and Japan. In addition to the above locations, we have various product development facilities, both domestically and internationally, as described under Research and Development (Part I, Item 1 of this Form 10-K).

In fiscal year 2017, the acquisition of LinkedIn Corporation increased our owned and leased space both domestically and internationally. We also sold various facilities related to the divestiture of our feature phone business.

The table below shows a summary of the square footage of our facilities owned and leased domestically and internationally as of June 30, 2017:

(Square feet in millions)

Location	Owned	Leased	Total
U.S.	17	13	30
International	6	12	18
Total	23	25	48

ITEM 3. LEGAL PROCEEDINGS

While not material to the Company, the Company makes the following annual report of the general activities of the Company's Antitrust Compliance Office as required by the Final Order and Judgment in *Barovic v. Ballmer et al*, United States District Court for the Western District of Washington ("Final Order"). For more information see

<http://aka.ms/MSLegalNotice2015>. These annual reports will continue through 2020. During fiscal year 2017, the Antitrust Compliance Office (a) monitored the Company's compliance with the European Commission Decision of March 24, 2004, ("2004 Decision") and with the Company's Public Undertaking to the European Commission dated December 16, 2009 ("2009 Undertaking"); (b) monitored, in the manner required by the Final Order, employee, customer, competitor, regulator, or other third-party complaints regarding compliance with the 2004 Decision, the 2009 Undertaking, or other EU or U.S. laws or regulations governing tying, bundling, and exclusive dealing contracts; and, (c) monitored, in the manner required by the Final Order, the training of the Company's employees regarding the Company's antitrust compliance policies. In addition, the Antitrust Compliance Officer reports to the Regulatory and Public Policy Committee of the Board at each of its regularly scheduled meetings and to the full Board annually.

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.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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

MARKET AND STOCKHOLDERS

Our common stock is traded on the NASDAQ Stock Market under the symbol MSFT. On July 31, 2017, there were 101,825 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
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Fiscal Year 2017

High	\$ 58.70	\$ 64.10	\$ 66.19	\$ 72.89	\$ 72.89
Low	50.39	56.32	61.95	64.85	50.39

Fiscal Year 2016

High	\$ 48.41	\$ 56.85	\$ 55.64	\$ 56.77	\$ 56.85
Low	39.72	43.75	48.19	48.04	39.72

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 further discussion regarding dividends and share repurchases. Following are our monthly stock repurchases for the fourth quarter of fiscal year 2017:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of
				Shares that May Yet be Purchased under the Plans or Programs

(in millions)

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April 1, 2017 – April 30, 2017	5,241,413	\$ 66.17	5,241,413	\$ 38,053
May 1, 2017 – May 31, 2017	9,635,700	\$ 68.77	9,635,700	\$ 37,391
June 1, 2017 – June 30, 2017	8,369,066	\$ 70.56	8,369,066	\$ 36,800
	23,246,179		23,246,179	

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

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ITEM 6. SELECTED FINANCIAL DATA

FINANCIAL HIGHLIGHTS

(In millions, except per share data)

Year Ended June 30,	2017	(a)	2016	2015	2014	(h)	2013	
Revenue	\$89,950	(b)	\$85,320	(d)	\$93,580	\$86,833	\$77,849	
Gross margin	55,689	(b)	52,540	(d)	60,542	59,755	57,464	
Operating income	22,326	(b)(c)	20,182	(d)(e)	18,161	(g) 27,759	26,764	(i)
Net income	21,204	(b)(c)	16,798	(d)(e)	12,193	(g) 22,074	21,863	(i)
Diluted earnings per share	2.71	(b)(c)	2.10	(d)(e)	1.48	(g) 2.63	2.58	(i)
Cash dividends declared per share	1.56		1.44		1.24	1.12	0.92	
Cash, cash equivalents, and short-term investments	132,981		113,240		96,526	85,709	77,022	
Total assets	241,086		193,468	(f)	174,303	(f) 170,569	(f) 140,890	(f)
Long-term obligations	104,165		62,114	(f)	44,574	(f) 35,285	(f) 24,531	(f)
Stockholders' equity	72,394		71,997		80,083	89,784	78,944	

(a) On December 8, 2016, we acquired LinkedIn Corporation. LinkedIn has been included in our consolidated results of operations starting on the acquisition date.

(b) Reflects the impact of the net revenue deferral from Windows 10 of \$6.7 billion, which decreased operating income, net income, and diluted earnings per share ("EPS") by \$6.7 billion, \$4.4 billion, and \$0.57, respectively.

(c) Includes \$306 million of employee severance expenses primarily related to our sales and marketing restructuring plan, which decreased operating income, net income, and diluted EPS by \$306 million, \$243 million, and \$0.03, respectively.

(d) Reflects the impact of the net revenue deferral from Windows 10 of \$6.6 billion, which decreased operating income, net income, and diluted EPS by \$6.6 billion, \$4.6 billion, and \$0.58, respectively.

(e) Includes \$630 million of asset impairment charges related to our phone business, and \$480 million of restructuring charges associated with our phone business restructuring plans, which together decreased operating income, net income, and diluted EPS by \$1.1 billion, \$895 million, and \$0.11, respectively.

(f) Reflects the impact of the adoption of the new accounting standard in fiscal year 2017 related to balance sheet classification of debt issuance costs. See Note 12 – Debt of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for further discussion.

(g) Includes \$7.5 billion of goodwill and asset impairment charges related to our phone business, and \$2.5 billion of integration and restructuring expenses, primarily associated with our phone business restructuring plans, which together decreased operating income, net income, and diluted EPS by \$10.0 billion, \$9.5 billion, and \$1.15, respectively.

(h)

On April 25, 2014, we acquired substantially all of Nokia Corporation's Devices and Services business ("NDS"). NDS has been included in our consolidated results of operations starting on the acquisition date.

- (i) Includes a charge related to a fine imposed by the European Commission in March 2013 which decreased operating income and net income by \$733 million (€561 million) and diluted EPS by \$0.09. Also includes a charge for Surface RT inventory adjustments recorded in the fourth quarter of fiscal year 2013, which decreased operating income, net income, and diluted EPS by \$900 million, \$596 million, and \$0.07, respectively.

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Item 7

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

OVERVIEW

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our strategy is to build best-in-class platforms and productivity services for an intelligent cloud and an intelligent edge infused with artificial intelligence ("AI"). We develop, license, and support a wide range of software products, services, and devices that deliver new opportunities, greater convenience, and enhanced value to people's lives. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

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

Highlights* from fiscal year 2017 included:

- Commercial cloud annualized revenue run rate** exceeded \$18.9 billion.
- Office Commercial revenue grew 6%, driven by Office 365 commercial revenue growth of 46%.
- Office Consumer revenue grew 14%, and Office 365 consumer subscribers increased to 27.0 million.
- Microsoft Dynamics revenue grew 9%, driven by Dynamics 365 revenue growth of 78%.
- LinkedIn contributed revenue of \$2.3 billion.
- Server products and cloud services revenue grew 13%, driven by Microsoft Azure revenue growth of 99%.
- Enterprise Services revenue decreased 2%, driven by a decline in revenue from custom support agreements, offset in part by higher revenue from Premier Support Services and Microsoft Consulting Services.
- Windows original equipment manufacturer licensing ("Windows OEM") revenue increased 3%.
- Windows Commercial revenue grew 5%, driven by multi-year agreement revenue.
- Microsoft Surface revenue decreased 2%, driven by a reduction in volumes sold, offset in part by a higher mix of premium devices.
- Search advertising revenue, excluding traffic acquisition costs, grew 9%.
- Gaming revenue decreased slightly, driven by lower Xbox hardware revenue, offset in part by growth in Xbox software and services.

* Highlights are presented based on segment results.

**

Commercial cloud annualized revenue run rate is calculated by multiplying revenue for the last month of the quarter by twelve for Office 365 commercial, Azure, Dynamics 365, and other cloud properties. On December 8, 2016, we completed our acquisition of LinkedIn Corporation for a total purchase price of \$27.0 billion. LinkedIn has been included in our consolidated results of operations since the date of acquisition. See Note 9 – Business Combinations in the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for further discussion.

In November 2016, we completed the sale of our feature phone business for \$350 million.

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In July 2015, we announced a plan to restructure our phone business to better focus and align resources. In May 2016, we announced plans to further streamline our smartphone hardware business. Our change in phone strategy resulted in a reduction in units sold and associated expenses in fiscal year 2016 and 2017.

Industry Trends

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

Economic Conditions, Challenges, and Risks

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

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

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. The strengthening of the U.S. dollar relative to certain foreign currencies throughout fiscal year 2015, 2016, and 2017, negatively impacted reported revenue and reduced reported expenses from our international operations.

See a discussion of these factors and other risks under Risk Factors (Part I, Item 1A of this Form 10-K).

Seasonality

Our revenue historically has fluctuated quarterly and has generally been highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers.

Reportable Segments

We report our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. The segment amounts included in MD&A are presented on a basis

consistent with our internal management reporting. All differences between our internal management reporting basis and accounting principles generally accepted in the United States (“U.S. GAAP”), along with certain corporate-level and other activity, are included in Corporate and Other. We have recast certain previously reported amounts to conform to the way we internally manage and monitor segment performance.

Additional information on our reportable segments is contained in Note 21 – Segment Information and Geographic Data of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).

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SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	2017	2016	2015	Percentage Change 2017 Versus 2016	Percentage Change 2016 Versus 2015
Revenue	\$89,950	\$85,320	\$93,580	5%	(9)%
Gross margin	55,689	52,540	60,542	6%	(13)%
Operating income	22,326	20,182	18,161	11%	11%
Diluted earnings per share	2.71	2.10	1.48	29%	42%

Fiscal year 2017 compared with fiscal year 2016

Revenue increased \$4.6 billion or 5%, driven by growth in Productivity and Business Processes and Intelligent Cloud, offset in part by lower revenue from More Personal Computing. Productivity and Business Processes revenue increased, driven by the acquisition of LinkedIn and higher revenue from Microsoft Office. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue decreased, mainly due to lower revenue from Devices, offset in part by higher revenue from Windows and Search advertising. Revenue included an unfavorable foreign currency impact of 2%.

Gross margin increased \$3.1 billion or 6%, due to growth across each of our segments, including the acquisition of LinkedIn, driven by higher revenue. Gross margin included an unfavorable foreign currency impact of 2%. Gross margin percentage increased slightly due to a margin percent increase in More Personal Computing and segment sales mix, offset in part by margin percent declines in Productivity and Business Processes and Intelligent Cloud. Gross margin percentage includes a 5-point improvement in commercial cloud gross margin primarily across Azure and Office 365.

Operating income increased \$2.1 billion or 11%, primarily due to higher gross margin and lower impairment, integration, and restructuring expenses, offset in part by an increase in research and development and sales and marketing expenses. Operating income included an operating loss of \$948 million related to the acquisition of LinkedIn, including \$866 million of amortization of intangible assets. Operating income also included an unfavorable foreign currency impact of 4%. Key changes in expenses were:

- Cost of revenue increased \$1.5 billion or 5%, mainly due to growth in our commercial cloud, the acquisition of LinkedIn, and higher Search advertising traffic acquisition costs, offset in part by a reduction in phone sales and Gaming cost of revenue.
- Research and development expenses increased \$1.0 billion or 9%, primarily due to LinkedIn expenses and increased investments in cloud engineering, offset in part by a reduction in phone expenses.
- Sales and marketing expenses increased \$842 million or 6%, primarily due to LinkedIn expenses and increased investments in sales capacity for our commercial cloud, offset in part by a reduction in phone and marketing expenses.

Impairment, integration, and restructuring expenses decreased \$804 million, driven by prior year asset impairment charges and restructuring charges related to our phone business, offset in part by current year employee severance expenses primarily related to our sales and marketing restructuring plan.

Diluted earnings per share ("EPS") was \$2.71 for fiscal year 2017. Current year diluted EPS was negatively impacted by the net revenue deferral from Windows 10 and restructuring expenses, which resulted in a decrease in diluted EPS of \$0.60. Diluted EPS was \$2.10 for fiscal year 2016. Prior year diluted EPS was negatively impacted by the net revenue deferral from Windows 10 and impairment and restructuring expenses, which resulted in a decrease in diluted EPS of \$0.69.

Fiscal year 2016 compared with fiscal year 2015

Revenue decreased \$8.3 billion or 9%, primarily due to the impact of the net revenue deferral from Windows 10 of \$6.6 billion and an unfavorable foreign currency impact of approximately \$3.8 billion or 4%. Windows 10 revenue is primarily recognized at the time of billing in the More Personal Computing segment, and the deferral and subsequent recognition of revenue is reflected in Corporate and Other. More Personal Computing revenue decreased, mainly due to lower revenue from Devices and Windows, offset in part by higher revenue from Search advertising and Gaming. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services and Enterprise Services. Productivity and Business Processes revenue increased slightly, driven by an increase in Office and Dynamics revenue.

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Operating income increased \$2.0 billion or 11%, primarily due to a decrease in impairment, integration, and restructuring expenses and sales and marketing expenses, offset in part by lower gross margin. Gross margin decreased \$8.0 billion or 13%, driven by the decline in revenue as discussed above, and included an unfavorable foreign currency impact of approximately \$3.3 billion or 5%. Productivity and Business Processes and More Personal Computing gross margin decreased, offset in part by higher gross margin from Intelligent Cloud.

Key changes in expenses were:

• Cost of revenue decreased \$258 million or 1%, mainly due to a reduction in phone sales, driven by the change in strategy for the phone business, offset in part by growth in commercial cloud and Search advertising.

• Impairment, integration, and restructuring expenses decreased \$8.9 billion, primarily driven by prior year goodwill and asset impairment charges related to our phone business and restructuring charges associated with our phone business restructuring plans.

• Sales and marketing expenses decreased \$1.0 billion or 6%, driven by a reduction in phone expenses and a favorable foreign currency impact of approximately 2%.

Diluted EPS was \$2.10 for fiscal year 2016. Diluted EPS was negatively impacted by the net revenue deferral from Windows 10 and impairment, integration, and restructuring expenses, which resulted in a decrease to diluted EPS of \$0.69. Diluted EPS was \$1.48 for fiscal year 2015. Diluted EPS was negatively impacted by impairment, integration, and restructuring expenses, which resulted in a decrease to diluted EPS of \$1.15.

SEGMENT RESULTS OF OPERATIONS

(In millions, except percentages)	2017	2016	2015	Percentage Change 2017 Versus 2016	Percentage Change 2016 Versus 2015
Revenue					
Productivity and Business Processes	\$30,444	\$26,487	\$26,430	15%	0%
Intelligent Cloud	27,440	25,042	23,715	10%	6%
More Personal Computing	38,773	40,434	43,435	(4)%	(7)%
Corporate and Other	(6,707)	(6,643)	0	(1)%	*
Total	\$89,950	\$85,320	\$93,580	5%	(9)%
Operating income (loss)					
Productivity and Business Processes	\$11,913	\$12,418	\$13,274	(4)%	(6)%
Intelligent Cloud	9,138	9,315	9,803	(2)%	(5)%
More Personal Computing	8,288	6,202	5,095	34%	22%

Corporate and Other (7,013) (7,753) (10,011) * *

Total	\$22,326	\$20,182	\$18,161	11%	11%
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*Not meaningful
Reportable Segments

Fiscal year 2017 compared with fiscal year 2016

Productivity and Business Processes

Revenue increased \$4.0 billion or 15%, driven by the acquisition of LinkedIn and higher revenue from Office.

LinkedIn revenue was \$2.3 billion, primarily comprised of revenue from Talent Solutions.

Office Commercial revenue increased \$1.2 billion or 6%, driven by higher revenue from Office 365 commercial, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.

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Office Consumer revenue increased \$425 million or 14%, driven by higher revenue from Office 365 consumer, mainly due to growth in subscribers.

Dynamics revenue increased 9%, primarily due to higher revenue from Dynamics 365.

Operating income decreased \$505 million or 4%, primarily due to higher operating expenses, offset in part by higher gross margin. Operating income included an unfavorable foreign currency impact of 3%.

Operating expenses increased \$2.4 billion or 26%, mainly due to LinkedIn and cloud engineering expenses.

Operating expenses included \$2.3 billion related to our acquisition of LinkedIn, including \$359 million of amortization of acquired intangible assets. Sales and marketing expenses increased \$1.2 billion or 24%, research and development expenses increased \$955 million or 35%, and general and administrative expenses increased \$212 million or 14%.

Gross margin increased \$1.8 billion or 9%, primarily due to our acquisition of LinkedIn. Gross margin percentage decreased due to an increased mix of cloud offerings and amortization of acquired intangible assets related to LinkedIn. Cost of revenue included \$918 million related to our acquisition of LinkedIn, including \$507 million of amortization of acquired intangible assets.

Intelligent Cloud

Revenue increased \$2.4 billion or 10%, primarily due to higher revenue from server products and cloud services.

Server products and cloud services revenue grew \$2.5 billion or 13%, driven by Azure revenue growth of 99% and server products licensed on-premises revenue growth of 4%.

Enterprise Services revenue decreased 2%, driven by a decline in revenue from custom support agreements, offset in part by higher revenue from Premier Support Services and Microsoft Consulting Services.

Operating income decreased \$177 million or 2%, primarily due to higher operating expenses, offset in part by higher gross margin. Operating income included an unfavorable foreign currency impact of 3%.

Operating expenses increased \$973 million or 11%, driven by investments in sales capacity, cloud engineering, and developer engagement. Sales and marketing expenses increased \$547 million or 13%, research and development expenses increased \$468 million or 14%, and general and administrative expenses decreased \$42 million or 3%.

Gross margin increased \$796 million or 4%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies, offset in part by a decline in Enterprise Services gross margin. Gross margin included an unfavorable foreign currency impact of 2%. Gross margin percentage decreased due to an increased mix of cloud offerings and lower Enterprise Services gross margin percent, offset by improvement in Azure gross margin percent.

More Personal Computing

Revenue decreased \$1.7 billion or 4%, mainly due to lower revenue from Devices, offset in part by higher revenue from Windows and Search advertising.

Windows revenue increased \$442 million or 3%, mainly due to higher revenue from Windows OEM and Windows Commercial. Windows OEM revenue increased 3%. Windows OEM Pro revenue grew 5%, outperforming the commercial PC market, primarily due to a higher mix of premium licenses sold. Windows OEM non-Pro revenue grew 1%, outperforming the consumer PC market, primarily due to a higher mix of premium devices sold. Windows Commercial revenue grew 5%, driven by multi-year agreement revenue.

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Search advertising revenue increased \$791 million or 15%. Search advertising revenue, excluding traffic acquisition costs, increased 9%, primarily driven by growth in Bing, due to higher revenue per search and search volume. Gaming revenue decreased slightly, primarily due to lower Xbox hardware revenue, offset in part by higher revenue from Xbox software and services. Xbox hardware revenue decreased 21%, mainly due to lower prices of consoles sold and a decline in volume of consoles sold. Xbox software and services revenue increased 11%, driven by a higher volume of Xbox Live transactions and revenue per transaction.

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Surface revenue decreased \$82 million or 2%, primarily due to a reduction in volumes sold, offset in part by a higher mix of premium devices.

Phone revenue decreased \$2.8 billion.

Operating income increased \$2.1 billion or 34%, due to lower operating expenses and higher gross margin. Operating income included an unfavorable foreign currency impact of 4%.

Operating expenses decreased \$1.5 billion or 12%, driven by a reduction in phone expenses and Surface launch-related expenses in the prior year. Sales and marketing expenses decreased \$892 million or 16%, research and development expenses decreased \$374 million or 6%, and general and administrative expenses decreased \$252 million or 16%.

Gross margin increased \$568 million or 3%, driven by growth in Windows, Search advertising, and Gaming, offset in part by a decline in Phone and Surface. Gross margin percentage increased due to favorable sales mix and gross margin percent improvements across Gaming, Windows, and Search advertising, offset by a gross margin percent decline in Devices. Gross margin included an unfavorable foreign currency impact of 2%.

Fiscal year 2016 compared with fiscal year 2015

Productivity and Business Processes

Productivity and Business Processes revenue increased slightly, primarily due to an increase in Office and Dynamics revenue. Revenue included an unfavorable foreign currency impact of approximately 6%.

Office Commercial revenue increased \$135 million or 1%, driven by higher revenue from Office 365 commercial, mainly due to growth in subscribers, offset by lower transactional license volume, reflecting a continued shift to Office 365 commercial and a decline in the business PC market. Revenue included an unfavorable foreign currency impact of approximately 6%.

Office Consumer revenue decreased \$69 million or 2%, driven by a decline in the consumer PC market, offset in part by higher revenue from Office 365 consumer, mainly due to growth in subscribers. Revenue included an unfavorable foreign currency impact of approximately 4%.

Dynamics revenue increased 4%, mainly due to higher revenue from Dynamics CRM Online, driven by seat growth. Revenue included an unfavorable foreign currency impact of approximately 6%.

Productivity and Business Processes operating income decreased \$856 million or 6%, driven by lower gross margin. Gross margin decreased \$928 million or 4%, primarily due to higher cost of revenue. Gross margin included an unfavorable foreign currency impact of approximately 6%. Cost of revenue increased \$985 million or 25%, primarily due to an increased mix of cloud offerings. Operating expenses decreased \$72 million or 1%, driven by lower sales and marketing expenses. Sales and marketing expenses decreased \$82 million or 2%, mainly due to a reduction in headcount-related expenses and lower fees paid to third-party enterprise software advisors.

Intelligent Cloud

Intelligent Cloud revenue increased \$1.3 billion or 6%, primarily due to higher server products and cloud services revenue and Enterprise Services revenue. Revenue included an unfavorable foreign currency impact of approximately 5%.

Server products and cloud services revenue grew \$686 million or 4%, driven by revenue growth from Azure of 113%, offset in part by a decline in transactional revenue from our on-premises server products. Revenue included an

unfavorable foreign currency impact of approximately 5%.

Enterprise Services revenue grew \$536 million or 11%, mainly due to growth in Premier Support Services. Revenue included an unfavorable foreign currency impact of approximately 5%.

Intelligent Cloud operating income decreased \$488 million or 5%, primarily due to higher operating expenses, offset in part by higher gross margin. Operating expenses increased \$989 million or 12%, mainly due to higher research and development expenses and sales and marketing expenses. Research and development expenses increased \$567 million or 21% and sales and marketing expenses increased \$347 million or 9%, driven by increased strategic investments and acquisitions to drive cloud sales capacity and innovation. Gross margin increased \$501 million or 3%, driven by revenue growth, offset in part by higher cost of revenue. Gross margin included an unfavorable foreign currency impact of approximately 5%. Cost of revenue increased \$826 million or 14%, primarily driven by an increased mix of cloud services.

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More Personal Computing

More Personal Computing revenue decreased \$3.0 billion or 7%, mainly due to lower revenue from Devices and Windows, offset in part by higher revenue from Search advertising and Gaming. Revenue included an unfavorable foreign currency impact of approximately 2%.

Devices revenue decreased \$4.0 billion or 33%, mainly due to lower revenue from phones, driven by the change in strategy for the phone business, offset in part by higher Surface revenue. Phone revenue decreased \$4.2 billion or 56%, as we sold 13.8 million Microsoft Lumia phones and 75.5 million other phones in fiscal year 2016, compared with 36.8 million and 126.8 million sold, respectively, in fiscal year 2015. Surface revenue increased \$207 million or 5%, primarily driven by the release of Surface Pro 4 and Surface Book in the second quarter of fiscal year 2016, as well as the release of Surface 3 in the fourth quarter of fiscal year 2015, offset in part by a decline in revenue from Surface Pro 3. Devices revenue included an unfavorable foreign currency impact of approximately 3%.

Windows revenue decreased \$958 million or 5%, mainly due to lower revenue from patent licensing, Windows OEM, and Windows Phone licensing. Patent licensing revenue decreased 27%, due to a decline in license revenue per unit and licensed units. Windows OEM revenue decreased 1%. Windows OEM Pro revenue declined 6%, driven by a decline in the business PC market. Windows OEM non-Pro revenue increased 7%, outperforming the consumer PC market, driven by a higher mix of premium licenses sold. Windows Phone licensing revenue decreased 64%, driven by the recognition of deferred revenue in fiscal year 2015 from Windows Phone 8. Windows revenue included an unfavorable foreign currency impact of approximately 2%.

Search advertising revenue increased \$1.7 billion or 46%. Search advertising revenue, excluding traffic acquisition costs, increased 17%, primarily driven by growth in Bing, due to higher revenue per search and search volume. Search advertising revenue included an unfavorable foreign currency impact of approximately 2%.

Gaming revenue increased \$75 million or 1%, primarily due to higher revenue from Xbox Live and video games, offset in part by lower Xbox hardware revenue. Xbox Live revenue increased 17%, driven by higher revenue per transaction and volume of transactions. Video games revenue grew 28%, driven by the launch of Halo 5 and sales of Minecraft. We acquired Mojang AB, the Swedish video game developer of the Minecraft gaming franchise, in November 2014. Xbox hardware revenue decreased 16%, mainly due to lower prices of Xbox One consoles sold and a decline in Xbox 360 console volume, offset in part by higher Xbox One console volume. Gaming revenue included an unfavorable foreign currency impact of approximately 4%.

More Personal Computing operating income increased \$1.1 billion or 22%, primarily due to lower operating expenses, offset in part by lower gross margin. Operating expenses decreased \$2.0 billion or 13%, mainly due to lower sales and marketing expenses and research and development expenses. Sales and marketing expenses decreased \$1.3 billion or 19% and research and development expenses decreased \$676 million or 10%, driven by a reduction in phone expenses. Gross margin decreased \$932 million or 5%, reflecting lower revenue, offset in part by a reduction in cost of revenue. Gross margin included an unfavorable foreign currency impact of approximately 5%. Cost of revenue decreased \$2.1 billion or 9%, primarily driven by a reduction in phone sales, offset in part by higher search advertising cost of revenue.

Corporate and Other

Corporate and Other revenue is comprised of revenue deferrals related to Windows 10. Corporate and Other operating income (loss) is comprised of revenue deferrals related to Windows 10 and corporate-level activity not specifically allocated to a segment, including impairment, integration, and restructuring expenses.

Fiscal year 2017 compared with fiscal year 2016

Revenue decreased \$64 million, due to an increase in the net revenue deferral from Windows 10. During fiscal year 2017 and 2016, we deferred net revenue from Windows 10 of \$6.7 billion and \$6.6 billion, respectively.

Corporate and Other operating loss decreased \$740 million, primarily due to an \$804 million reduction in impairment, integration, and restructuring expenses, driven by prior year goodwill and asset impairment charges and restructuring charges related to our phone business, offset in part by current year employee severance expenses primarily related to our sales and marketing restructuring plan.

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Fiscal year 2016 compared with fiscal year 2015

Corporate and Other revenue decreased \$6.6 billion, due to the net revenue deferral from Windows 10.

Corporate and Other operating loss decreased \$2.3 billion, primarily due to an \$8.9 billion reduction in impairment, integration, and restructuring expenses, driven by prior year goodwill and asset impairment charges related to our phone business, offset in part by lower revenue.

OPERATING EXPENSES

Research and Development

(In millions, except percentages)	2017	2016	2015	Percentage Change 2017 Versus 2016	Percentage Change 2016 Versus 2015
Research and development	\$13,037	\$11,988	\$12,046	9%	0%
As a percent of revenue	14%	14%	13%	0ppt	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.

Fiscal year 2017 compared with fiscal year 2016

Research and development expenses increased \$1.0 billion or 9%, primarily due to LinkedIn expenses and increased investments in cloud engineering, offset in part by a reduction in phone expenses. Expenses included \$745 million related to our acquisition of LinkedIn.

Fiscal year 2016 compared with fiscal year 2015

Research and development expenses decreased \$58 million, primarily due to a reduction in phone expenses, driven by the change in strategy for the phone business, offset in part by increased strategic investments and acquisitions to drive cloud innovation.

Sales and Marketing

(In millions, except percentages)	2017	2016	2015	Percentage Change 2017	Percentage Change 2016
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Sales and marketing	\$15,539	\$14,697	\$15,713	6%	(6)%
As a percent of revenue	17%	17%	17%	Oppt	Oppt

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 2017 compared with fiscal year 2016

Sales and marketing expenses increased \$842 million or 6%, primarily due to LinkedIn expenses and increased investments in sales capacity for our commercial cloud, offset in part by a reduction in phone expenses and prior year marketing expenses primarily related to Surface, commercial, and Windows 10. Expenses included \$1.3 billion related to our acquisition of LinkedIn, including \$359 million of amortization of acquired intangible assets.

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Fiscal year 2016 compared with fiscal year 2015

Sales and marketing expenses decreased \$1.0 billion or 6%, primarily due to a reduction in phone expenses, driven by the change in strategy for the phone business. Expenses included a favorable foreign currency impact of approximately 2%.

General and Administrative

(In millions, except percentages)	2017	2016	2015	Percentage Change 2017 Versus 2016	Percentage Change 2016 Versus 2015
General and administrative	\$4,481	\$4,563	\$4,611	(2)%	(1)%
As a percent of revenue	5%	5%	5%	0ppt	0ppt

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

Fiscal year 2017 compared with fiscal year 2016

General and administrative expenses decreased \$82 million or 2%, primarily due to prior year investments in infrastructure supporting our business transformation, a reduction in phone expenses, and lower employee-related expenses, offset in part by LinkedIn expenses. Expenses included \$294 million related to our acquisition of LinkedIn.

Fiscal year 2016 compared with fiscal year 2015

General and administrative expenses decreased \$48 million or 1%, primarily due to a reduction in employee-related expenses, offset in part by increased investments in infrastructure supporting our business transformation. Expenses included a favorable foreign currency impact of approximately 2%.

IMPAIRMENT, INTEGRATION, AND RESTRUCTURING EXPENSES

Impairment, integration, and restructuring expenses include costs associated with the impairment of goodwill and intangible assets related to our phone business, employee severance expenses and costs associated with the consolidation of facilities and manufacturing operations related to restructuring activities, and systems consolidation and other business integration expenses associated with our acquisition of Nokia Corporation's Devices and Services business ("NDS").

Fiscal year 2017 compared with fiscal year 2016

Impairment, integration, and restructuring expenses were \$306 million for fiscal year 2017, compared to \$1.1 billion for fiscal year 2016.

During fiscal year 2017, we recorded \$306 million of employee severance expenses primarily related to our sales and marketing restructuring plan. During fiscal year 2016, we recorded \$630 million of asset impairment charges related to our phone business. We also recorded \$480 million of restructuring charges, including employee severance expenses and contract termination costs, primarily related to our previously announced phone business restructuring plans.

Fiscal year 2016 compared with fiscal year 2015

Impairment, integration, and restructuring expenses were \$1.1 billion for fiscal year 2016, compared to \$10.0 billion for fiscal year 2015.

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During fiscal year 2015, we recognized impairment charges of \$7.5 billion related to our phone business. Our annual goodwill impairment test as of May 1, 2015 indicated that the carrying value of our previous Phone Hardware reporting unit goodwill exceeded its estimated fair value. Accordingly, we recorded a goodwill impairment charge of \$5.1 billion, reducing our Phone Hardware reporting unit goodwill from \$5.4 billion to \$116 million, net of foreign currency remeasurements, as well as an impairment charge of \$2.2 billion related to the write-down of our Phone Hardware reporting unit intangible assets. All remaining goodwill and intangible assets are included in our Devices reporting unit, within More Personal Computing under our current segment structure. Restructuring charges were \$2.1 billion, including employee severance expenses and the write-down of certain assets in connection with our restructuring activities. Integration expenses associated with the acquisition of NDS were \$435 million in fiscal year 2015.

OTHER INCOME (EXPENSE), NET

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

(In millions)

Year Ended June 30,	2017	2016	2015
Dividends and interest income	\$1,387	\$903	\$766
Interest expense	(2,222)	(1,243)	(781)
Net recognized gains on investments	2,583	668	716
Net losses on derivatives	(510)	(443)	(423)
Net gains (losses) on foreign currency remeasurements	(164)	(121)	335
Other	(251)	(195)	(267)
Total	\$823	\$(431)	\$346

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

Fiscal year 2017 compared with fiscal year 2016

Dividends and interest income increased primarily due to higher portfolio balances and yields on fixed-income securities. Interest expense increased primarily due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities. Net losses on derivatives increased due to higher losses on equity derivatives, offset in part by lower losses on commodity and foreign currency

derivatives. Other, net reflects recognized losses from certain joint ventures and divestitures.

Fiscal year 2016 compared with fiscal year 2015

Dividends and interest income increased due to higher portfolio balances and slightly higher yields on fixed-income securities. Interest expense increased due to higher outstanding long-term debt. Net recognized gains on investments decreased primarily due to higher other-than-temporary impairments and lower gains on sales of fixed-income securities, offset in part by higher gains on sales of equity securities. Net losses on derivatives increased due to higher losses on currency and equity contracts and lower gains on interest rate contracts in the current period as compared to the prior period, offset in part by lower losses on commodity contracts. For fiscal year 2016, other reflects recognized losses from divestitures and certain joint ventures.

INCOME TAXES

Fiscal year 2017 compared with fiscal year 2016

Our effective tax rate for fiscal years 2017 and 2016 was 8% and 15%, respectively. The decrease in our effective tax rate for fiscal year 2017 compared to fiscal year 2016 was primarily due to the realization of tax benefits attributable to previous phone business losses, offset in part by changes in the mix of our income before income

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taxes between the U.S. and foreign countries. The fiscal year 2016 effective tax rate included the impact of nondeductible phone charges and valuation allowances. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico. Additionally, our effective tax rate in fiscal year 2017 reflects the realization of tax benefits attributable to previous phone business losses.

The mix of income before income taxes between the U.S. and foreign countries impacted our effective tax rate as a result of the geographic distribution of, and customer demand for, our products and services. We supply our Windows PC operating system to customers through our U.S. regional operating center, while we supply the Microsoft Office system and our server products and tools to customers through our foreign regional operations centers. In fiscal year 2017, our U.S. income before income taxes was \$453 million and our foreign income before income taxes was \$22.7 billion. Net revenue deferrals related to sales of Windows 10 negatively impacted our fiscal year 2017 U.S. income before income taxes by \$6.4 billion and foreign income before income taxes by \$317 million. In fiscal year 2016, our U.S. loss before income taxes was \$325 million and our foreign income before income taxes was \$20.1 billion. Net revenue deferrals related to sales of Windows 10 negatively impacted our fiscal year 2016 U.S. loss by \$6.0 billion and foreign income before income taxes by \$588 million.

Tax contingencies and other income tax liabilities were \$13.5 billion and \$11.8 billion as of June 30, 2017 and 2016, respectively, and are included in other long-term liabilities. This increase relates primarily to current period intercompany transfer pricing and tax credits.

While we settled a portion of the Internal Revenue Service (“IRS”) audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and settled a portion of the IRS audit for tax years 2007 to 2009 during the first quarter of fiscal year 2016, we remain under audit for those years. We also continue to be subject to examination by the IRS for tax years 2010 to 2016. In February 2012, the IRS withdrew its 2011 Revenue Agents Report for tax years 2004 to 2006 and reopened the audit phase of the examination. As of June 30, 2017, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2017, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

Fiscal year 2016 compared with fiscal year 2015

Our effective tax rate for fiscal years 2016 and 2015 was 15% and 34%, respectively. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

The decrease in our effective tax rate for fiscal year 2016 compared to fiscal year 2015 was primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries including the impact of net revenue deferrals related to sales of Windows 10, tax benefits from the adoption of the new accounting guidance relating to stock-based compensation, and distributions from foreign affiliates. The fiscal year 2015 effective tax rate included the tax impact of losses in foreign jurisdictions for which we may not realize a tax benefit, primarily as a result of impairment and restructuring charges.

The mix of income before income taxes between the U.S. and foreign countries impacted our effective tax rate as a result of the geographic distribution of, and customer demand for, our products and services. We supply our Windows PC operating system to customers through our U.S. regional operating center, while we supply the Microsoft Office system and our server products and tools to customers through our foreign regional operations centers. In fiscal year 2016, our U.S. loss before income taxes was \$325 million and our foreign income before income taxes was \$20.1 billion. Net revenue deferrals related to sales of Windows 10 negatively impacted our fiscal year 2016 U.S. loss before income taxes by \$6.0 billion and foreign income before income taxes by \$588 million. In fiscal year 2015, our U.S. income before income taxes was \$7.4 billion and our foreign income before income taxes was \$11.1 billion. Impairment, integration, and restructuring expense relating to our phone business decreased our fiscal year 2015 U.S. income before income taxes by \$1.1 billion and foreign income before income taxes by \$8.9 billion.

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FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled \$133.0 billion as of June 30, 2017, compared with \$113.2 billion as of June 30, 2016. Equity and other investments were \$6.0 billion as of June 30, 2017, compared with \$10.4 billion as of June 30, 2016. Our short-term investments are primarily intended to facilitate liquidity and for capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities.

Of the cash, cash equivalents, and short-term investments as of June 30, 2017, \$127.9 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash, cash equivalents, and short-term investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was \$2.4 billion. As of June 30, 2017, approximately 87% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 3% were invested in U.S. mortgage- and asset-backed securities, and approximately 2% were invested in corporate notes and bonds of U.S. companies, all of which are denominated in U.S. dollars. The remaining cash equivalents and short-term investments held by our foreign subsidiaries were primarily invested in foreign securities.

Securities lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our consolidated balance sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash collateral received is recorded as an asset with a corresponding liability. Our securities lending payable balance was \$97 million as of June 30, 2017. Our average and maximum securities lending payable balances for fiscal year 2017 were \$484 million and \$1.5 billion, respectively. Intra-year variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

Valuation

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

portion of our portfolio.

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

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PART II

Item 7

Cash Flows

Fiscal year 2017 compared with fiscal year 2016

Cash from operations increased \$6.2 billion to \$39.5 billion during the fiscal year, mainly due to an increase in cash received from customers and an income tax refund for overpayment of estimated taxes, offset in part by an increase in cash paid to employees. Cash from financing increased \$16.8 billion to \$8.4 billion, mainly due to a \$13.2 billion increase in proceeds from issuances of debt, net of repayments, and a \$4.2 billion decrease in cash used for common stock repurchases, offset in part by an \$839 million increase in dividends paid. Cash used in investing increased \$22.8 billion to \$46.8 billion, mainly due to a \$24.6 billion increase in cash used for acquisitions of companies, net of cash acquired, and purchases of intangibles and other assets, offset in part by a \$1.9 billion decrease in cash used for net investment purchases, sales, and maturities.

Fiscal year 2016 compared with fiscal year 2015

Cash from operations increased \$3.7 billion to \$33.3 billion during the fiscal year, mainly due to lower operating expenditures and a reduction in materials and production costs, offset in part by a decrease in cash received from customers. Cash used in financing decreased \$1.3 billion to \$8.4 billion, mainly due to a \$4.6 billion increase in proceeds from issuances of debt, net of repayments, offset in part by a \$1.5 billion increase in cash used for common stock repurchases and a \$1.1 billion increase in dividends paid. Cash used in investing increased \$949 million to \$24.0 billion, mainly due to a \$2.4 billion increase in cash used for additions to property and equipment and a \$1.5 billion increase in cash used for net investment purchases, sales, and maturities, offset in part by a \$2.3 billion decrease in cash used for acquisitions of companies, net of cash acquired, and purchases of intangibles and other assets.

Debt

We issued debt to take advantage of favorable pricing and liquidity in the debt markets, reflecting our credit rating and the low interest rate environment. The proceeds of these issuances were or will be used for general corporate purposes, which may include, among other things, funding for working capital, capital expenditures, repurchases of capital stock, acquisitions, and repayment of existing debt. See Note 12 – Debt of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K) for further discussion.

Unearned Revenue

Unearned revenue as of June 30, 2017 was comprised mainly of unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each coverage period and accounted for as subscriptions with revenue recognized ratably over the coverage period. Unearned revenue as of June 30, 2017 also included payments for: Windows 10 licenses; post-delivery support and consulting services to be performed in the future; Office 365 subscriptions; LinkedIn; Xbox Live subscriptions; Dynamics business solutions products; Skype prepaid credits and subscriptions; 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, 2017:

(In millions)

Three Months Ending,

September 30, 2017	\$12,544
December 31, 2017	9,993
March 31, 2018	7,307
June 30, 2018	