MICROSOFT CORP
Form 10-Q
January 27, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended December 31, 2010

OR

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

Commission File Number: 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

(425) 882-8080

(Registrant s telephone number, including area code)

None

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

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

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

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

Large accelerated filer x
Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)
Smaller reporting company ¨

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

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

Class	**Outstanding at January 21, 2011**
Common Stock, $0.00000625 par value per share	8,402,382,031 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2010

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PART I

Item 1

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Revenue	**$ 19,953**	$ 19,022	**$ 36,148**	$ 31,942
Operating expenses:				
Cost of revenue	**4,833**	3,628	**7,972**	6,470
Research and development	**2,185**	2,079	**4,381**	4,144
Sales and marketing	**3,825**	3,619	**6,631**	6,409
General and administrative	**945**	1,183	**1,883**	1,924
Total operating expenses	**11,788**	10,509	**20,867**	18,947
Operating income	**8,165**	8,513	**15,281**	12,995
Other income	**332**	370	**446**	653
Income before income taxes	**8,497**	8,883	**15,727**	13,648
Provision for income taxes	**1,863**	2,221	**3,683**	3,412
Net income	**$ 6,634**	$ 6,662	**$ 12,044**	$ 10,236
Earnings per share:				
Basic	**$ 0.78**	$ 0.75	**$ 1.41**	$ 1.15
Diluted	**$ 0.77**	$ 0.74	**$ 1.39**	$ 1.14
Weighted average shares outstanding:				
Basic	**8,497**	8,856	**8,555**	8,885
Diluted	**8,570**	8,951	**8,646**	8,975
Cash dividends declared per common share	**$ 0.16**	$ 0.13	**$ 0.32**	$ 0.26

See accompanying notes.

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BALANCE SHEETS

(In millions)

	December 31, 2010 (Unaudited)	June 30, 2010[1]
Assets		
Current assets:		
Cash and cash equivalents	**$ 4,023**	$ 5,505
Short-term investments (including securities loaned of **$982** and $62)	**37,229**	31,283
Total cash, cash equivalents, and short-term investments	**41,252**	36,788
Accounts receivable, net of allowance for doubtful accounts of **$317** and $375	**12,874**	13,014
Inventories	**861**	740
Deferred income taxes	**2,548**	2,184
Other	**2,149**	2,950
Total current assets	**59,684**	55,676
Property and equipment, net of accumulated depreciation of **$9,279** and $8,629	**7,799**	7,630
Equity and other investments	**10,022**	7,754
Goodwill	**12,502**	12,394
Intangible assets, net	**992**	1,158
Other long-term assets	**1,307**	1,501
Total assets	**$ 92,306**	$ 86,113
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,863**	$ 4,025
Short-term debt	**0**	1,000
Accrued compensation	**2,402**	3,283
Income taxes	**1,439**	1,074
Short-term unearned revenue	**12,063**	13,652
Securities lending payable	**1,355**	182
Other	**3,190**	2,931
Total current liabilities	**24,312**	26,147
Long-term debt	**9,671**	4,939
Long-term unearned revenue	**1,354**	1,178
Deferred income taxes	**826**	229
Other long-term liabilities	**7,662**	7,445
Total liabilities	**43,825**	39,938
Commitments and contingencies		
Stockholders equity:		

Common stock and paid-in capital shares authorized 24,000; outstanding **8,403** and 8,668	**61,646**	62,856
Retained deficit, including accumulated other comprehensive income of **$1,697** and $1,055	**(13,165)**	(16,681)
Total stockholders equity	**48,481**	46,175
Total liabilities and stockholders equity	**$ 92,306**	$ 86,113

(1) *Derived from audited financial statements.*

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Operations				
Net income	**$ 6,634**	$ 6,662	**$ 12,044**	$ 10,236
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	**663**	615	**1,357**	1,261
Stock-based compensation expense	**553**	485	**1,081**	928
Net recognized gains on investments and derivatives	**(226)**	(188)	**(255)**	(254)
Excess tax benefits from stock-based compensation	**(4)**	(15)	**(9)**	(24)
Deferred income taxes	**(117)**	550	**(265)**	504
Deferral of unearned revenue	**6,834**	6,926	**12,715**	13,605
Recognition of unearned revenue	**(7,301)**	(9,126)	**(14,163)**	(15,363)
Changes in operating assets and liabilities:				
Accounts receivable	**(3,270)**	(2,789)	**404**	(41)
Inventories	**380**	558	**(88)**	139
Other current assets	**(77)**	686	**131**	451
Other long-term assets	**118**	16	**180**	(62)
Accounts payable	**216**	3	**(184)**	(33)
Other current liabilities	**(500)**	282	**(1,411)**	(921)
Other long-term liabilities	**283**	304	**843**	650
Net cash from operations	**4,186**	4,969	**12,380**	11,076
Financing				
Short-term debt repayments, maturities of 90 days or less, net	**(1,000)**	(475)	**(186)**	(97)
Proceeds from issuance of debt, maturities longer than 90 days	**0**	1,046	**4,721**	1,741
Repayments of debt, maturities longer than 90 days	**0**	(573)	**(814)**	(1,396)
Common stock issued	**660**	729	**837**	977
Common stock repurchased	**(5,052)**	(3,867)	**(9,451)**	(5,407)
Common stock cash dividends paid	**(1,363)**	(1,152)	**(2,481)**	(2,309)
Excess tax benefits from stock-based compensation	**4**	15	**9**	24
Other	**0**	0	**(25)**	0
Net cash used in financing	**(6,751)**	(4,277)	**(7,390)**	(6,467)
Investing				
Additions to property and equipment	**(491)**	(376)	**(1,055)**	(811)
Acquisition of companies, net of cash acquired	**(69)**	(63)	**(69)**	(102)
Purchases of investments	**(5,896)**	(4,287)	**(13,313)**	(14,777)
Maturities of investments	**1,836**	1,896	**2,706**	5,394
Sales of investments	**2,603**	3,361	**4,030**	7,778
Securities lending payable	**447**	(623)	**1,174**	1,227

Net cash used in investing	**(1,570)**	(92)	**(6,527)**	(1,291)
Effect of exchange rates on cash and cash equivalents	**(3)**	(1)	**55**	28
Net change in cash and cash equivalents	**(4,138)**	599	**(1,482)**	3,346
Cash and cash equivalents, beginning of period	**8,161**	8,823	**5,505**	6,076
Cash and cash equivalents, end of period	**$ 4,023**	$ 9,422	**$ 4,023**	$ 9,422

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Common stock and paid-in capital				
Balance, beginning of period	**$ 61,935**	$ 62,293	**$ 62,856**	$ 62,382
Common stock issued	**660**	779	**837**	1,027
Common stock repurchased	**(1,405)**	(923)	**(2,980)**	(1,656)
Stock-based compensation	**553**	485	**1,081**	928
Stock-based compensation income tax deficiencies	**(97)**	(68)	**(148)**	(115)
Balance, end of period	**61,646**	62,566	**61,646**	62,566
Retained deficit				
Balance, beginning of period	**(14,993)**	(21,081)	**(16,681)**	(22,824)
Net income	**6,634**	6,662	**12,044**	10,236
Other comprehensive income:				
Net unrealized losses on derivatives	**(80)**	(42)	**(586)**	(361)
Net unrealized gains on investments	**284**	65	**1,016**	653
Translation adjustments and other	**(26)**	(35)	**212**	61
Comprehensive income	**6,812**	6,650	**12,686**	10,589
Common stock cash dividends	**(1,337)**	(1,140)	**(2,699)**	(2,297)
Common stock repurchased	**(3,647)**	(2,712)	**(6,471)**	(3,751)
Balance, end of period	**(13,165)**	(18,283)	**(13,165)**	(18,283)
Total stockholders equity	**$ 48,481**	$ 44,283	**$ 48,481**	$ 44,283

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Basis of Presentation and Use of Estimates

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include: estimates of loss contingencies, product warranties, product life cycles, product returns, and stock-based compensation forfeiture rates; assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/enhancements and new products; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in our financial statements or tax returns; estimating the fair value and/or goodwill impairment for our reporting units; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management s estimates and assumptions.

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2010 Form 10-K filed on July 30, 2010 with the U.S. Securities and Exchange Commission.

Principles of Consolidation

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

Recently Adopted Accounting Guidance

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

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

Recent Accounting Guidance Not Yet Adopted

In January 2010, the FASB issued guidance to amend the disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant

unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on our financial statements.

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NOTE 2 EARNINGS PER SHARE

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

(In millions, except earnings per share)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Net income available for common shareholders (A)	**$ 6,634**	$ 6,662	**$ 12,044**	$ 10,236
Weighted average shares of common stock (B)	**8,497**	8,856	**8,555**	8,885
Dilutive effect of stock-based awards	**73**	95	**91**	90
Common stock and common stock equivalents (C)	**8,570**	8,951	**8,646**	8,975
Earnings Per Share:				
Basic (A/B)	**$ 0.78**	$ 0.75	**$ 1.41**	$ 1.15
Diluted (A/C)	**$ 0.77**	$ 0.74	**$ 1.39**	$ 1.14

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Shares excluded from calculations of diluted EPS	**56**	101	**57**	155

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

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

NOTE 3 OTHER INCOME

The components of other income were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Dividends and interest income	**$ 205**	$ 197	**$ 415**	$ 400
Interest expense	**(72)**	(38)	**(117)**	(76)
Net recognized gains on investments	**118**	92	**152**	162
Net gains on derivatives	**108**	96	**103**	92
Net gains (losses) on foreign currency remeasurements	**(27)**	(23)	**(69)**	32
Other	**0**	46	**(38)**	43
Total	**$ 332**	$ 370	**$ 446**	$ 653

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NOTE 4 INVESTMENTS

Investment Components

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

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
December 31, 2010							
Cash	**$ 1,811**	**$ 0**	**$ 0**	**$ 1,811**	**$ 1,811**	**$ 0**	**$ 0**
Mutual funds	**367**	**0**	**0**	**367**	**367**	**0**	**0**
Certificates of deposit	**1,100**	**0**	**0**	**1,100**	**742**	**358**	**0**
U.S. Government and Agency securities	**26,535**	**137**	**(7)**	**26,665**	**1,103**	**25,562**	**0**
Foreign government bonds	**553**	**13**	**0**	**566**	**0**	**566**	**0**
Mortgage-backed securities	**2,629**	**112**	**(6)**	**2,735**	**0**	**2,735**	**0**
Corporate notes and bonds	**7,118**	**311**	**(14)**	**7,415**	**0**	**7,415**	**0**
Municipal securities	**527**	**4**	**(5)**	**526**	**0**	**526**	**0**
Common and preferred stock	**7,197**	**2,337**	**(107)**	**9,427**	**0**	**0**	**9,427**
Other investments	**662**	**0**	**0**	**662**	**0**	**67**	**595**
Total	**$ 48,499**	**$ 2,914**	**$ (139)**	**$ 51,274**	**$ 4,023**	**$ 37,229**	**$ 10,022**

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2010							
Cash	$ 1,661	$ 0	$ 0	$ 1,661	$ 1,661	$ 0	$ 0
Mutual funds	1,120	0	0	1,120	1,120	0	0
Commercial paper	188	0	0	188	13	175	0
Certificates of deposit	348	0	0	348	68	280	0
U.S. Government and Agency securities	21,036	167	(1)	21,202	1,822	19,380	0
Foreign government bonds	518	13	0	531	0	531	0
Mortgage-backed securities	3,137	135	(7)	3,265	0	3,265	0
Corporate notes and bonds	7,450	289	(18)	7,721	701	7,020	0
Municipal securities	726	22	(1)	747	120	627	0
Common and preferred stock	6,640	1,030	(418)	7,252	0	0	7,252
Other investments	507	0	0	507	0	5	502
Total	$ 43,331	$ 1,656	$ (445)	$ 44,542	$ 5,505	$ 31,283	$ 7,754

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Unrealized Losses on Investments

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

	Less than 12 Months		12 Months or Greater		Total	
(In millions)	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Total Fair Value**	**Unrealized Losses**
December 31, 2010						
U.S. Government and Agency securities	**$ 2,013**	**$ (7)**	**$ 0**	**$ 0**	**$ 2,013**	**$ (7)**
Mortgage-backed securities	**79**	**(5)**	**16**	**(1)**	**95**	**(6)**
Corporate notes and bonds	**635**	**(13)**	**70**	**(1)**	**705**	**(14)**
Municipal securities	**255**	**(5)**	**0**	**0**	**255**	**(5)**
Common and preferred stock	**951**	**(80)**	**193**	**(27)**	**1,144**	**(107)**
Total	**$ 3,933**	**$ (110)**	**$ 279**	**$ (29)**	**$ 4,212**	**$ (139)**

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

Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses from domestic and international equities are due to market price movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of December 31, 2010.

At December 31, 2010 and June 30, 2010, the recorded bases and estimated fair values of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $279 million and $216 million, respectively.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
December 31, 2010		
Due in one year or less	$ 21,169	$ 21,273
Due after one year through five years	11,677	11,887
Due after five years through 10 years	2,397	2,513
Due after 10 years	3,219	3,334
Total	$ 38,462	$ 39,007

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NOTE 5 DERIVATIVES

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

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

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. As of December 31, 2010 and June 30, 2010, the total notional amounts of these foreign exchange contracts sold were $11.6 billion and $9.3 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of December 31, 2010 and June 30, 2010, the total notional amounts of these foreign exchange contracts sold were $543 million and $523 million, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of December 31, 2010, the total notional amounts of these foreign exchange contracts purchased and sold were $4.5 billion and $6.1 billion, respectively. As of June 30, 2010, the total notional amounts of these foreign exchange contracts purchased and sold were $7.8 billion and $5.3 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of December 31, 2010, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.5 billion and $1.1 billion, respectively. As of June 30, 2010, the total notional amounts of designated and non-designated equity contracts purchased and sold were $918 million and $472 million, respectively.

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of December 31, 2010, the total notional amounts of fixed-interest rate contracts purchased and sold were $1.0 billion and $433 million, respectively. As of June 30, 2010, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.1 billion and $1.8 billion, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of December 31, 2010 and June 30, 2010, the total notional derivative amount of mortgage contracts purchased were $645 million and $305 million, respectively.

Credit

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

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Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swap, futures and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of December 31, 2010, the total notional amounts of commodity contracts purchased and sold were $1.4 billion and $456 million, respectively. As of June 30, 2010, the total notional amounts of commodity contracts purchased and sold were $1.1 billion and $376 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain a minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of December 31, 2010, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral was required to be posted.

Fair Values of Derivative Instruments

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

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

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

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

Following are the gross fair values of derivative instruments designated as hedging instruments (designated hedge derivatives) and not designated as hedging instruments (non-designated hedge derivatives) that were held at December 31, 2010 and June 30, 2010. The fair values exclude the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk.

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(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
December 31, 2010						
Assets						
Non-designated hedge derivatives:						
Short-term investments	**$ 12**	**$ 173**	**$ 18**	**$ 11**	**$ 96**	**$ 310**
Other current assets	**46**	**0**	**0**	**0**	**0**	**46**
Total	**$ 58**	**$ 173**	**$ 18**	**$ 11**	**$ 96**	**$ 356**
Designated hedge derivatives:						
Short-term investments	**$ 2**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 2**
Other current assets	**142**	**0**	**0**	**0**	**0**	**142**
Total	**$ 144**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 144**
Total assets	**$ 202**	**$ 173**	**$ 18**	**$ 11**	**$ 96**	**$ 500**
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	**$ (48)**	**$ (11)**	**$ (6)**	**$ (13)**	**$ (34)**	**$ (112)**
Designated hedge derivatives:						
Other current liabilities	**$ (358)**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ (358)**
Total liabilities	**$ (406)**	**$ (11)**	**$ (6)**	**$ (13)**	**$ (34)**	**$ (470)**

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

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

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

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Fair Value Hedges

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Derivatives	**$ 2**	$ 89	**$ (50)**	$ (104)
Hedged items	**(2)**	(85)	**48**	103
Total	**$ 0**	$ 4	**$ (2)**	$ (1)

Cash Flow Hedges

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Effective Portion				
Gain (loss) recognized in OCI, net of tax effect of **$(24)** for the three months ended and **$(267)** for the six months ended December 31, 2010, and $1 for the three months and $(111) for the six months ended December 31, 2009	**$ (45)**	$ 2	**$ (497)**	$ (207)
Gain reclassified from OCI into revenue	**55**	68	**139**	237
Amount Excluded from Effectiveness Assessment and Ineffective Portion				
Gain (loss) recognized in other income	**(16)**	26	**(103)**	(14)

We estimate that $104 million of net derivative losses included in OCI will be reclassified into earnings within the next 12 months. No significant amounts of gains (losses) were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the three months and six months ended December 31, 2010 and 2009.

Non-Designated Derivatives

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). These amounts are shown in the table below, with the exception of gains (losses) on derivatives presented in income statement line items other than other income (expense), which were immaterial for the three months and six months ended December 31, 2010 and 2009. Other than those

derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities.

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Foreign exchange contracts	**$ (25)**	$ 47	**$ (85)**	$ 90
Equity contracts	**(2)**	7	**31**	16
Interest-rate contracts	**24**	9	**12**	12
Credit contracts	**10**	2	**28**	11
Commodity contracts	**93**	54	**158**	69
Total	**$ 100**	$ 119	**$ 144**	$ 198

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NOTE 6 FAIR VALUE MEASUREMENTS

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

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

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

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

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

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Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[a]	Net Fair Value
December 31, 2010						
Assets						
Mutual funds	**$ 367**	**$ 0**	**$ 0**	**$ 367**	**$ 0**	**$ 367**
Certificates of deposit	**0**	**1,100**	**0**	**1,100**	**0**	**1,100**
U.S. Government and Agency securities	**20,722**	**5,942**	**0**	**26,664**	**0**	**26,664**
Foreign government bonds	**257**	**316**	**0**	**573**	**0**	**573**
Mortgage-backed securities	**0**	**2,736**	**0**	**2,736**	**0**	**2,736**
Corporate notes and bonds	**0**	**7,067**	**171**	**7,238**	**0**	**7,238**
Municipal securities	**0**	**526**	**0**	**526**	**0**	**526**
Common and preferred stock	**9,085**	**58**	**5**	**9,148**	**0**	**9,148**
Derivatives	**17**	**468**	**15**	**500**	**(325)**	**175**
Total	**$ 30,448**	**$ 18,213**	**$ 191**	**$ 48,852**	**$ (325)**	**$ 48,527**
Liabilities						
Derivatives and other	**$ 93**	**$ 456**	**$ 0**	**$ 549**	**$ (325)**	**$ 224**

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

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

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

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

(In millions)

	December 31, 2010	June 30, 2010
Net fair value of assets measured at fair value on a recurring basis	**$ 48,527**	$ 42,645
Cash	**1,811**	1,661
Common and preferred stock measured at fair value on a nonrecurring basis	**279**	216
Other investments measured at fair value on a nonrecurring basis	**596**	502
Less derivative assets classified as other current assets	**(16)**	(544)
Other	**77**	62
Recorded basis of investment components	**$ 51,274**	$ 44,542

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

The following tables present the changes during the three months and six months ended December 31, 2010 and 2009 in our Level 3 financial instruments that are measured at fair value on a recurring basis. The majority of these instruments consist of investment securities classified as available-for-sale with changes in fair value included in OCI.

(In millions)	**Corporate Notes and Bonds**	**Common and Preferred Stock**	**Derivative Assets**	**Total**
Three Months and Six Months Ended December 31, 2010				
Balance as of June 30, 2010	**$ 167**	**$ 5**	**$ 9**	**$ 181**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**2**	**0**	**7**	**9**
Included in other comprehensive income	**(2)**	**0**	**0**	**(2)**
Balance as of September 30, 2010	**$ 167**	**$ 5**	**$ 16**	**$ 188**
Total realized and unrealized gains:				
Included in other income (expense)	**2**	**0**	**(1)**	**1**
Included in other comprehensive income	**2**	**0**	**0**	**2**
Balance as of December 31, 2010	**$ 171**	**$ 5**	**$ 15**	**$ 191**
Change in unrealized gains (losses) included in other income (expense) for the three months ended December 31, 2010 related to assets held as of December 31, 2010	**$ 2**	**$ 0**	**$ (1)**	**$ 1**

Change in unrealized gains (losses) included in other income (expense) for the six months ended December 31, 2010 related to assets held as of December 31, 2010	**$ 4**	**$ 0**	**$ 6**	**$ 10**

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

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

During the three months and six months ended December 31, 2010 and 2009, we did not record any other-than-temporary impairments on those assets required to be measured at fair value on a non-recurring basis.

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)	December 31, 2010	June 30, 2010
Raw materials	**$ 151**	$ 172
Work in process	**54**	16
Finished goods	**656**	552
Total	**$ 861**	$ 740

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NOTE 8 GOODWILL

Changes in our goodwill balances during the three months and six months ended December 31, 2010 were as follows:

(In millions)	Balance September 30, 2010	Acquisitions	Purchase Accounting Adjustments and Other	Balance December 31, 2010
Windows & Windows Live Division	$ 89	$ 0	$ 0	$ 89
Server and Tools	1,125	13	0	1,138
Online Services Division	6,373	0	0	6,373
Microsoft Business Division	4,102	0	(11)	4,091
Entertainment and Devices Division	782	30	(1)	811
Total	$ 12,471	$ 43	$ (12)	$ 12,502

(In millions)	Balance June 30, 2010	Acquisitions	Purchase Accounting Adjustments and Other	Balance December 31, 2010
Windows & Windows Live Division	$ 77	$ 0	$ 12	$ 89
Server and Tools	1,118	13	7	1,138
Online Services Division	6,373	0	0	6,373
Microsoft Business Division	4,024	0	67	4,091
Entertainment and Devices Division	802	30	(21)	811
Total	$ 12,394	$ 43	$ 65	$ 12,502

We do not expect any of the amounts recorded as goodwill to be deductible for tax purposes. The measurement period for purchase price allocations ends as soon as information on the facts and circumstances becomes available, but will not exceed 12 months. Adjustments in the purchase price allocation may require a recasting of the amounts allocated to goodwill retroactive to the period in which the acquisition

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

NOTE 9 INTANGIBLE ASSETS

The components of intangible assets were as follows:

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
			December 31, 2010			June 30, 2010
Contract-based	**$ 1,067**	**$ (935)**	**$ 132**	$ 1,075	$ (914)	$ 161
Technology-based	**2,321**	**(1,639)**	**682**	2,308	(1,521)	787
Marketing-related	**113**	**(91)**	**22**	114	(86)	28
Customer-related	**392**	**(236)**	**156**	390	(208)	182
Total	**$ 3,893**	**$ (2,901)**	**$ 992**	$ 3,887	$ (2,729)	$ 1,158

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Intangible assets amortization expense was $126 million for the three months and $250 million for the six months ended December 31, 2010 as compared with $169 million for the three months and $318 million for the six months ended December 31, 2009. The following table outlines the estimated future amortization expense related to intangible assets held at December 31, 2010:

(In millions)	
Year Ending June 30,	
2011 (excluding the six months ended December 31, 2010)	$ 252
2012	392
2013	251
2014	57
2015	16
2016 and thereafter	24
Total	$ 992

NOTE 10 DEBT

Short-term Debt

During the three months ended December 31, 2010, we repaid $1.0 billion of commercial paper, leaving zero outstanding.

On November 5, 2010, our $1.0 billion 364-day credit facility expired. This facility served as a back-up for our commercial paper program. No amounts were drawn against the credit facility during any of the periods presented.

Long-term Debt

As of December 31, 2010, the total carrying value and estimated fair value of our long-term debt, including convertible debt, were $9.7 billion and $9.8 billion, respectively. The estimated fair value is based on quoted prices for our publicly-traded debt as of December 31, 2010, as applicable.

The components of long-term debt and the associated interest rates and semi-annual interest record and payment dates were as follows as of December 31, 2010:

Due Date	Face Value	Interest Rate	Record Date	Pay Date	Record Date	Pay Date
Notes	**(In millions)**					
September 27, 2013	$ 1,000	0.875%	March 15	March 27	September 15	September 27
June 1, 2014	2,000	2.950%	May 15	June 1	November 15	December 1
September 25, 2015	1,750	1.625%	March 15	March 25	September 15	September 25
June 1, 2019	1,000	4.200%	May 15	June 1	November 15	December 1
October 1, 2020	1,000	3.000%	March 15	April 1	September 15	October 1

June 1, 2039	750	5.200%	May 15	June 1	November 15	December 1
October 1, 2040	1,000	4.500%	March 15	April 1	September 15	October 1
Convertible Debt						
June 15, 2013	1,250	0.000%				
Total unamortized discount	(79)					
Total	$ 9,671					

Notes

As of December 31, 2010, we had issued and outstanding $8.5 billion of debt securities as illustrated in the table above (collectively the Notes), including $4.75 billion of debt securities issued in September 2010. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

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Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Each $1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share.

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

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

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

NOTE 11 INCOME TAXES

Our effective tax rates were approximately 22% and 25% for the three months ended December 31, 2010 and 2009, respectively, and 23% and 25% for the six months ended December 31, 2010 and 2009, respectively. The reduction in the rate was due to a higher mix of earnings taxed at lower rates in foreign jurisdictions, and the retroactive extension of the research and development tax credit in the United States. Tax contingencies and other tax liabilities were $6.9 billion as of December 31, 2010 and June 30, 2010, and were included in other long-term liabilities.

NOTE 12 UNEARNED REVENUE

The components of unearned revenue were as follows:

(In millions)

	December 31, 2010	**June 30, 2010**
Volume licensing programs	**$ 11,119**	$ 12,180
Undelivered elements	**221**	624
Other	**2,077**	2,026
Total	**$ 13,417**	$ 14,830

Unearned revenue by segment was as follows:

(In millions)

	December 31, 2010	June 30, 2010
Windows & Windows Live Division	**$ 1,467**	$ 1,701
Server and Tools	**4,938**	5,282
Microsoft Business Division	**6,171**	7,004
Other segments	**841**	843
Total	**$ 13,417**	$ 14,830

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NOTE 13 COMMITMENTS AND GUARANTEES

Yahoo! Commercial Agreement

On December 4, 2009, we entered into a definitive agreement with Yahoo! whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. The term of the agreement is 10 years subject to termination provisions after five years based on performance.

Microsoft provided Yahoo! with revenue per search guarantees for a period of 18 months after implementation of the Microsoft search ads platform in each country. These guarantees are calculated, paid and trued-up periodically based on the cumulative reduction in revenue per search, if any, during the 18 month period from pre-implementation levels, except in the case of the U.S. and Canada where performance during each of the first two calendar quarters after implementation is independent and not cumulative. This is a rate guarantee and not a guarantee of search volume. We estimate the total cost of the revenue per search guarantees during the guarantee period could range up to $150 million.

Microsoft also agreed to reimburse Yahoo! for certain transition expenses incurred both before and after the effective date of the agreement.

Finally, Microsoft also agreed to reimburse Yahoo! for certain costs of running algorithmic and paid search services prior to migration to Microsoft s platform.

Product Warranty

Our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities, changed during the three months and six months ended December 31, 2010 as follows:

	Three Months Ended		Six Months Ended	
(In millions)	**December 31,**		**December 31,**	
	2010	**2009**	**2010**	**2009**
Balance, beginning of period	**$ 214**	$ 289	**$ 240**	$ 342
Accrual for warranties issued	**19**	61	**32**	94
Adjustments to pre-existing warranties	**0**	(2)	**0**	(2)
Settlements of warranty claims	**(31)**	(40)	**(70)**	(126)
Balance, end of period	**$ 202**	$ 308	**$ 202**	$ 308

NOTE 14 CONTINGENCIES

Government Competition Law Matters

We are subject to a Consent Decree and Final Judgment (Final Judgments) that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Final Judgments imposed various constraints on our Windows operating system businesses. The Final Judgments are scheduled to expire in May 2011.

In other ongoing investigations, various foreign governments and several state attorneys general have requested information from us concerning competition, privacy, and security issues.

Antitrust, Unfair Competition, and Overcharge Class Actions

A large number of antitrust and unfair competition class action lawsuits were filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals of damages claims of indirect purchasers under federal law and in 15 states. Courts refused to certify classes in two additional states. We have reached agreements to settle all claims that have been made to date in 19 states and the District of Columbia.

The settlements in all states have received final court approval. Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make

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claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers. We estimate the total cost to resolve all of the state overcharge class action cases will range between $1.9 billion and $2.0 billion. At December 31, 2010, we have recorded a liability related to these claims of approximately $593 million, which reflects our estimated exposure of $1.9 billion less payments made to date of approximately $1.3 billion mostly for vouchers, legal fees, and administrative expenses.

The three cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In March 2010, the court in the British Columbia case certified it as a class action. We have appealed this ruling. The other two actions have been stayed.

Other Antitrust Litigation and Claims

In November 2004, Novell, Inc. filed a complaint in U.S. District Court for the District of Utah (later transferred to federal court in Maryland), asserting antitrust and unfair competition claims against us related to Novell s ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. In March 2010 the trial court granted summary judgment in favor of Microsoft as to all remaining claims. Novell has appealed that ruling.

Patent and Intellectual Property Claims

In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents (although this action began before the merger of Alcatel and Lucent in 2006, for simplicity we refer to the post-merger entity of Alcatel-Lucent). In April 2008, a jury returned a verdict in Alcatel-Lucent s favor in a trial on a consolidated group of one video and three user interface patents. The jury concluded that we had infringed two user interface patents and awarded $367 million in damages. In June 2008, the trial judge increased the amount of damages to $512 million to include $145 million of interest. We appealed that award to the Federal Circuit. In December 2008, we entered into a settlement agreement resolving all other litigation pending between Microsoft and Alcatel-Lucent, leaving approximately $500 million remaining in dispute. In September 2009, the United States Court of Appeals for the Federal Circuit affirmed the liability award but vacated the verdict and remanded the case to the trial court for a re-trial of the damages ruling, indicating the damages previously awarded were too high. Trial on the remanded damages claim is set to begin in July 2011.

In October 2003, Uniloc USA Inc., a subsidiary of a Singapore-based company, filed a patent infringement suit in U.S. District Court in Rhode Island, claiming that product activation technology supporting Windows XP and certain other Microsoft programs violated a Uniloc patent. After we obtained a favorable summary judgment that we did not infringe any of the claims of this patent, the court of appeals vacated the trial court decision and remanded the case for trial. In April 2009, the jury returned a $388 million verdict against us, including a finding of willful infringement. In September 2009, the district court judge overturned the jury verdict, ruling that the evidence did not support the jury s findings either that Microsoft infringed the patent or was willful. Uniloc appealed, and in January 2011, the court of appeals reversed the district court s finding of non-infringement (thus reinstating the jury verdict of infringement) but affirmed the district court s ruling that Microsoft was not willful and affirmed the district court s grant of a new trial on damages. We are exploring our options for further appellate review.

In March 2007, i4i Limited Partnership sued Microsoft in U.S. District Court in Texas claiming that certain custom XML technology in Word 2003 and 2007 infringed i4i s patent. In May 2009, a jury returned a verdict against us, finding damages of $200 million and that we willfully infringed the patent. In August 2009, the court denied our post-trial motions and awarded enhanced damages of $40 million and prejudgment interest of $37 million. The court also issued a permanent injunction prohibiting additional distribution of the allegedly infringing technology. We appealed and the appellate court stayed the injunction pending our appeal. In December 2009, the court of appeals rejected our appeal and affirmed the trial court s judgment and injunction, except that the court of appeals modified the effective date of the injunction to January 11, 2010. In November 2010, the U.S. Supreme Court granted our petition seeking review of the case; we expect oral argument in April 2011 and a decision in June 2011.

In October 2010, we filed suit against Motorola with the International Trade Commission and in U.S. District Court in Washington for infringement of nine Microsoft patents by Motorola s Android-based smartphones. In addition, in November 2010, we filed suit against Motorola in U.S. District Court in Washington for breach of Motorola s contractual commitments to the Institute of Electrical and Electronics Engineers

(IEEE) and International Telecommunications Union (ITU) to license identified patents related to wireless and video coding technologies under reasonable and non-discriminatory terms and conditions. In November 2010, Motorola filed two patent infringement actions against us in U.S. District Court in Wisconsin and one in U.S. District Court in Florida on a total of sixteen patents asserted variously against Windows, Windows Phone 7, Windows Mobile 6.5, Xbox, Bing Maps, Hotmail, Messenger and Exchange Server.

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In addition to these cases, there are approximately 45 other patent infringement cases pending against Microsoft.

Other

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

As of December 31, 2010, we had accrued aggregate liabilities of $877 million in other current liabilities and $336 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could reach approximately $950 million in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.

NOTE 15 STOCKHOLDERS EQUITY

Share Repurchases

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Shares of common stock repurchased	**188**	125	**351**	183
Value of common stock repurchased	**$ 5,000**	$ 3,583	**$ 9,000**	$ 5,028

We repurchased all shares with cash resources. As of December 31, 2010, approximately $14.7 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

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

Declaration Date	Per Share Dividend	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal year 2011				
September 21, 2010	**$ 0.16**	**November 18, 2010**	**$ 1,363**	**December 9, 2010**
December 15, 2010	**$ 0.16**	**February 17, 2011**	**$ 1,344**	**March 10, 2011**
Fiscal year 2010				

September 18, 2009	$ 0.13	November 19, 2009	$ 1,152	December 10, 2009
December 9, 2009	$ 0.13	February 18, 2010	$ 1,139	March 11, 2010

The estimate of the amount to be paid as a result of the December 15, 2010 declaration was included in other current liabilities as of December 31, 2010.

NOTE 16 SEGMENT INFORMATION

In its operation of the business, management, including our chief operating decision maker, the Company s Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segment information within this note is reported on that basis. Our five segments are Windows & Windows Live Division; Server and Tools; Online Services Division; Microsoft Business Division; and Entertainment and Devices Division.

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

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

We have recast certain prior period amounts within this note to conform to the way we internally managed and monitored segment performance during the current fiscal year.

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Revenue				
Windows & Windows Live Division	**$ 4,985**	$ 5,361	**$ 9,690**	$ 9,590
Server and Tools	**4,392**	3,980	**8,354**	7,528
Online Services Division	**691**	578	**1,218**	1,065
Microsoft Business Division	**5,811**	4,868	**10,908**	9,367
Entertainment and Devices Division	**3,653**	2,417	**5,422**	3,850
Unallocated and other	**421**	1,818	**556**	542
Consolidated	**$ 19,953**	$ 19,022	**$ 36,148**	$ 31,942
Operating income (loss)				
Windows & Windows Live Division	**$ 3,189**	$ 3,575	**$ 6,393**	$ 6,392
Server and Tools	**1,758**	1,421	**3,352**	2,610
Online Services Division	**(562)**	(477)	**(1,140)**	(973)
Microsoft Business Division	**3,731**	2,924	**7,038**	5,687
Entertainment and Devices Division	**636**	363	**1,002**	623
Reconciling amounts	**(587)**	707	**(1,364)**	(1,344)
Consolidated	**$ 8,165**	$ 8,513	**$ 15,281**	$ 12,995

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

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Significant reconciling items were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Corporate-level activity [(a)]	**$ (963)**	$ (1,217)	**$ (2,011)**	$ (2,052)
Stock-based compensation	**65**	108	**244**	268
Revenue reconciling amounts [(b)]	**333**	1,791	**464**	428
Other	**(22)**	25	**(61)**	12
Total	**$ (587)**	$ 707	**$ (1,364)**	$ (1,344)

(a) *Corporate-level activity excludes stock-based compensation and revenue reconciling amounts presented separately in those line items.*

(b) *For the three months ended December 31, 2009, revenue reconciling amounts include the recognition of previously deferred revenue related to sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost and sales of Windows 7 to original equipment manufacturers and retailers before general availability.*

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation) as of December 31, 2010, and the related consolidated statements of income, cash flows, and stockholders equity for the three-month and six-month periods ended December 31, 2010 and 2009. These interim financial statements are the responsibility of the Corporation s management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2010, and the related consolidated statements of income, cash flows, and stockholders equity for the year then ended (not presented herein); and in our report dated July 30, 2010 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2010 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Seattle, Washington

January 27, 2011

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

NOTE ABOUT FORWARD-LOOKING STATEMENTS

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

OVERVIEW

Management s discussion and analysis is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended June 30, 2010 and the Consolidated Financial Statements and accompanying notes (Notes) included in this Form 10-Q.

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

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

Global macroeconomic factors have a strong correlation to demand for our software, services, hardware, and online offerings. The current macroeconomic factors remain dynamic and uncertain. Irrespective of global economic conditions, we are positive about our relative market position, our current product portfolio, and future product pipeline. Because we offer a wide range of products and services that enable companies to improve productivity and reduce costs, including cloud-based services, we believe that Microsoft is well-positioned to create new opportunities to increase revenue as the global economy improves. We remain focused on executing in the areas we can control by continuing to provide high value products at the lowest total cost of ownership while managing our expenses.

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All growth and percentage comparisons refer to the three months and six months ended December 31, 2010, as compared with the three months and six months ended December 31, 2009, unless otherwise noted.

RESULTS OF OPERATIONS

Summary

(In millions, except per share amounts and percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	2009		2010	2009	
Revenue	**$ 19,953**	$ 19,022	5%	**$ 36,148**	$ 31,942	13%
Operating income	**$ 8,165**	$ 8,513	(4)%	**$ 15,281**	$ 12,995	18%
Diluted earnings per share	**$ 0.77**	$ 0.74	4%	**$ 1.39**	$ 1.14	22%

Three months ended December 31, 2010 compared with three months ended December 31, 2009

Revenue increased primarily due to strong sales of the Xbox 360 console and accessories, including Kinect, the 2010 Microsoft Office system, and Server and Tools products. This increase was offset in part by the recognition in the prior year of approximately $1.7 billion of revenue related to the Windows 7 Deferral. Changes in foreign currency exchange rates had an insignificant impact on revenue.

Operating income decreased reflecting higher operating expenses, offset in part by the change in revenue. Key changes in operating expenses were:

Cost of revenue increased $1.2 billion or 33%, primarily reflecting increased volumes of Xbox 360 consoles and accessories sold and higher costs associated with our online offerings.

General and administrative expenses decreased $238 million or 20%, due mainly to a decrease in legal charges and employee severance, offset in part by higher headcount-related expenses.

Sales and marketing expenses increased $206 million or 6%, primarily reflecting increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live.

Research and development expenses increased $106 million or 5%, due mainly to higher headcount-related expenses.

Six months ended December 31, 2010 compared with six months ended December 31, 2009

Revenue increased primarily due to strong sales of the Xbox 360 console, accessories and video games, the 2010 Microsoft Office system, and Server and Tools products. Changes in foreign currency exchange rates had an insignificant impact on revenue.

Operating income increased reflecting the change in revenue, offset in part by higher operating expenses. Key changes in operating expenses were:

Cost of revenue increased $1.5 billion or 23%, primarily reflecting increased volumes of Xbox 360 consoles and accessories sold and higher costs associated with our online offerings.

Research and development expenses increased $237 million or 6%, due mainly to higher headcount-related expenses and third-party development and programming costs.

Sales and marketing expenses increased $222 million or 3%, primarily reflecting increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, and higher headcount-related expenses.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the U.S. (U.S. GAAP) and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 16 Segment Information of the Notes to Financial Statements (Part I, Item I of this Form 10-Q) is presented on a basis consistent with our current internal management

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reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. We have recast certain prior period amounts within this MD&A to conform to the way we internally managed and monitored segment performance during the current fiscal year.

Windows & Windows Live Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	**2009**		**2010**	**2009**	
Revenue	**$ 5,054**	$ 7,193	(30)%	**$ 9,839**	$ 10,063	(2)%
Operating income	**$ 3,251**	$ 5,417	(40)%	**$ 6,573**	$ 6,894	(5)%

Windows & Windows Live Division (Windows Division) develops and markets PC operating systems and related software and online services. The Windows Division offerings consist of multiple editions of the Windows operating system, software and services through Windows Live, and Microsoft PC hardware products.

Windows Division revenue growth is largely correlated to the growth of the PC market worldwide as approximately 75% of total Windows Division revenue comes from pre-installed versions of the Windows operating system purchased by original equipment manufacturers (OEMs). The remaining approximately 25% of Windows Division revenue (other revenue) is generated by commercial and retail sales of Windows and PC hardware products and online advertising from Windows Live.

Three months ended December 31, 2010 compared with three months ended December 31, 2009

Windows Division revenue decreased primarily due to the prior year launch of Windows 7, including recognition of approximately $1.7 billion of revenue in the prior year related to the Windows 7 Deferral. OEM revenue decreased $1.8 billion or 32%. This decrease was driven by the prior year launch of Windows 7, reflecting a decrease in inventory in our distribution channels, and lower Windows attach rates in China, partially offset by PC market growth. Other revenue decreased $314 million or 20%, driven primarily by the prior year launch of Windows 7. Considering the impact of the Windows 7 launch in the prior year, we estimate Windows Division revenue growth was in line with PC market growth. We estimate total worldwide PC shipments from all sources grew approximately 2% to 4%.

Windows Division operating income decreased primarily as a result of decreased revenue. In addition, sales and marketing expenses increased $22 million or 3% reflecting increased advertising of Windows and Windows Live.

Six months ended December 31, 2010 compared with six months ended December 31, 2009

Windows Division revenue decreased due to the prior year launch of Windows 7, partially offset by PC market growth. OEM revenue decreased $43 million or 1%. This decrease was driven by the prior year launch of Windows 7, reflecting a decrease in inventory in our distribution channels, and lower Windows attach rates in China, partially offset by PC market growth. Other revenue decreased $181 million or 7%, driven primarily by the prior year launch of Windows 7. Considering the impact of the Windows 7 launch in the prior year, we estimate Windows Division revenue growth was in line with PC market growth. We estimate total worldwide PC shipments from all sources grew approximately 6% to 8%.

Windows Division operating income decreased as a result of decreased revenue and higher operating expenses. Sales and marketing expenses increased $46 million or 3% reflecting increased advertising of Windows and Windows Live. Cost of revenue increased $31 million or 3%,

primarily driven by higher traffic acquisition costs, partially offset by decreased product and services costs.

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Server and Tools

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	**2009**		**2010**	**2009**	
Revenue	**$ 4,390**	$ 3,978	10%	**$ 8,349**	$ 7,523	11%
Operating income	**$ 1,776**	$ 1,464	21%	**$ 3,415**	$ 2,709	26%

Server and Tools develops and markets technology and related services that enable information technology professionals and their systems to be more productive and efficient. Server and Tools product and service offerings include Windows Server, Microsoft SQL Server, Windows Azure, Windows Embedded device platforms and Enterprise Services. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. We also offer developer tools, training and certification. Approximately 50% of Server and Tools revenue comes primarily from multi-year volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

Three months ended December 31, 2010 compared with three months ended December 31, 2009

Server and Tools revenue increased reflecting growth in both product and Enterprise Services. Product revenue increased $343 million or 11%, driven primarily by growth in Windows Server, SQL Server, Enterprise Client Access License (CAL) Suites, and developer tools, reflecting continued adoption of Windows platform applications. Enterprise Services revenue grew $69 million or 9%, due to growth in both Premier product support and consulting services.

Server and Tools operating income increased primarily due to revenue growth, offset in part by higher cost of revenue. Cost of revenue increased $62 million or 9%, reflecting higher expenses from providing services and online offerings.

Six months ended December 31, 2010 compared with six months ended December 31, 2009

Server and Tools revenue increased reflecting growth in both product and Enterprise Services. Product revenue increased $690 million or 11%, driven primarily by growth in Windows Server, SQL Server, Enterprise CAL Suites, and Windows Embedded, reflecting continued adoption of Windows platform applications. Enterprise Services revenue grew $136 million or 9%, due to growth in both Premier product support and consulting services.

Server and Tools operating income increased primarily due to revenue growth, offset in part by an increase in cost of revenue. Cost of revenue increased $117 million or 8%, reflecting higher expenses from providing services and online offerings.

Online Services Division

(In millions, except percentages)	Three Months Ended December 31,	Percentage Change	Six Months Ended December 31,	Percentage Change

	2010	2009		2010	2009	
Revenue	**$ 691**	$ 579	19%	**$ 1,218**	$ 1,067	14%
Operating loss	**$ (543)**	$ (463)	(17)%	**$ (1,103)**	$ (940)	(17)%

Online Services Division (OSD) develops and markets information and communication services that help people find what they want online and that help advertisers connect with audiences. OSD offerings include Bing, MSN, and advertiser and publisher tools. Bing and MSN generate revenue through the sale of search and display advertising.

Three months ended December 31, 2010 compared with three months ended December 31, 2009

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew $117 million or 23% to $632 million, reflecting continued growth in Bing, offset in part by decreased third party advertising revenue.

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OSD operating loss increased due to higher cost of revenue and research and development expenses, offset in part by increased revenue. Cost of revenue grew $110 million driven by costs associated with the Yahoo! search agreement. Research and development expenses grew $68 million or 28%, primarily due to headcount-related expenses associated with the search portion of the business.

Six months ended December 31, 2010 compared with six months ended December 31, 2009

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew $171 million or 18% to $1.1 billion, reflecting continued growth in Bing, offset in part by decreased third party advertising revenue.

OSD operating loss increased due to higher cost of revenue and research and development expenses, offset in part by increased revenue. Cost of revenue grew $184 million driven by costs associated with the Yahoo! search agreement. Research and development expenses grew $129 million or 28%, primarily due to headcount-related expenses associated with the search portion of the business.

Microsoft Business Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	**2009**		**2010**	**2009**	
Revenue	**$ 6,032**	$ 4,864	24%	**$ 11,157**	$ 9,360	19%
Operating income	**$ 3,965**	$ 2,947	35%	**$ 7,340**	$ 5,744	28%

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

Three months ended December 31, 2010 compared with three months ended December 31, 2009

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system, which was released primarily during the fourth quarter of fiscal year 2010. Business revenue increased $697 million or 18%, primarily reflecting licensing of the 2010 Microsoft Office system to transactional business customers, growth in multi-year volume licensing revenue, and a 7% increase in Microsoft Dynamics revenue. Consumer revenue increased $471 million or 49% due to sales of the 2010 Microsoft Office system. The growth in consumer revenue includes the recognition of $224 million of revenue associated with the Office Deferral.

MBD operating income increased due mainly to revenue growth, offset in part by higher cost of revenue and research and development costs. Cost of revenue increased $94 million or 30%, primarily driven by higher online costs and costs of providing services. Research and development costs increased $33 million or 7%, primarily as a result of capitalization of certain Microsoft Office system software development costs in the prior year.

Six months ended December 31, 2010 compared with six months ended December 31, 2009

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system. Business revenue increased $1.1 billion or 15%, primarily reflecting licensing of the 2010 Microsoft Office system to transactional business customers, growth in multi-year volume licensing

revenue, and a 6% increase in Microsoft Dynamics revenue. Consumer revenue increased $697 million or 39% due to sales of the 2010 Microsoft Office system and growth in the PC market. The growth in consumer revenue includes the recognition of $254 million of revenue associated with the Office Deferral.

MBD operating income increased due mainly to revenue growth, offset in part by higher cost of revenue. Cost of revenue increased $174 million or 30%, primarily driven by higher online costs and costs of providing services.

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Entertainment and Devices Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	2009		2010	2009	
Revenue	**$ 3,698**	$ 2,381	55%	**$ 5,493**	$ 3,815	44%
Operating income	**$ 679**	$ 365	86%	**$ 1,067**	$ 640	67%

Entertainment and Devices Division (EDD) develops and markets products and services designed to entertain and connect people. EDD offerings include the Xbox 360 platform (which includes the Xbox 360 gaming and entertainment console, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories, including Kinect for Xbox 360), Mediaroom (our Internet protocol television software), and Windows Phone. In November 2010, we released Kinect for Xbox 360 and the latest version of Windows Phone. Windows Phone revenue is recognized on a straight-line basis over the estimated economic life of the software.

Three months ended December 31, 2010 compared with three months ended December 31, 2009

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue. Xbox 360 platform revenue grew $1.3 billion or 56%, led by sales of Kinect sensors, increased volumes of Xbox 360 consoles and video games sold, and Xbox LIVE. We shipped 6.3 million Xbox 360 consoles and 8 million Kinect sensors (including those sold with consoles) during the second quarter of fiscal year 2011, compared with 5.2 million Xbox 360 consoles during the second quarter of fiscal year 2010. Xbox 360 video game revenue increased primarily reflecting sales of Kinect game titles.

EDD operating income increased primarily reflecting revenue growth, offset in part by higher operating expenses. Cost of revenue increased $906 million or 61% primarily reflecting higher volumes of Xbox 360 consoles and Kinect sensors sold, and increased royalty costs resulting from increased Xbox LIVE digital content sold. Sales and marketing expenses grew $57 million or 20% primarily reflecting increased Xbox 360 platform marketing activities. Research and development expenses increased $35 million or 15%, primarily reflecting higher headcount-related expenses.

Six months ended December 31, 2010 compared with six months ended December 31, 2009

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue. Xbox 360 platform revenue grew $1.7 billion or 47%, led by sales of Kinect sensors, increased volumes of Xbox 360 consoles and video games sold, and Xbox LIVE. We shipped 9.2 million Xbox 360 consoles and 8 million Kinect sensors (including those sold with consoles) during the first half of fiscal year 2011, compared with 7.3 million Xbox 360 consoles during the first half of fiscal year 2010. Xbox 360 video game revenue increased primarily reflecting sales of Halo Reach and Kinect game titles.

EDD operating income increased primarily reflecting revenue growth, offset in part by higher operating expenses. Cost of revenue increased $1.1 billion or 46% primarily reflecting higher volumes of Xbox 360 consoles and Kinect sensors sold. Research and development expenses increased $103 million or 23%, primarily reflecting higher headcount-related expenses. Sales and marketing expenses grew $85 million or 20% primarily reflecting increased Xbox 360 platform marketing activities.

Corporate-Level Activity

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	2009		2010	2009	
Corporate-level activity	**$ (963)**	$ (1,217)	21%	**$ (2,011)**	$ (2,052)	2%

Certain corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; and legal settlements and contingencies. For the three months ended December 31, 2010, corporate-level expenses decreased due mainly to a $225 million decrease in legal

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charges and a 2% decrease in headcount-related expenses. For the six months ended December 31, 2010, corporate-level expenses decreased due mainly to a $112 million decrease in legal charges, offset in part by a 2% increase in headcount-related expenses.

OPERATING EXPENSES

Cost of Revenue

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	2009		2010	2009	
Cost of revenue	**$ 4,833**	$ 3,628	33%	**$ 7,972**	$ 6,470	23%
As a percent of revenue	**24%**	19%	5ppt	**22%**	20%	2ppt

Cost of revenue includes: manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our Web sites and to acquire online advertising space (traffic acquisition costs); costs incurred to support and maintain Internet-based products and services; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs. Cost of revenue increased primarily due to increased volumes of Xbox 360 consoles and accessories sold and higher costs associated with our online offerings.

Research and Development

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	2009		2010	2009	
Research and development	**$ 2,185**	$ 2,079	5%	**$ 4,381**	$ 4,144	6%
As a percent of revenue	**11%**	11%	0ppt	**12%**	13%	(1)ppt

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. The increase in research and development expenses was primarily driven by a 4% increase in headcount-related expenses, the capitalization of certain software development costs in the prior year, and higher third-party development and programming costs, partially offset by a decrease in localization and lab costs.

Sales and Marketing

(In millions, except percentages)	Three Months Ended December 31,	Percentage Change	Six Months Ended December 31,	Percentage Change

	2010	2009		2010	2009	
Sales and marketing	**$ 3,825**	$ 3,619	6%	**$ 6,631**	$ 6,409	3%
As a percent of revenue	**19%**	19%	0ppt	**18%**	20%	(2)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and the costs of advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses increased primarily as a result of increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, and a 2% increase in headcount-related expenses.

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General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2010	2009		2010	2009	
General and administrative	**$ 945**	$ 1,183	(20)%	**$ 1,883**	$ 1,924	(2)%
As a percent of revenue	**5%**	6%	(1)ppt	**5%**	6%	(1)ppt

General and administrative expenses include payroll, employee benefits, stock-based compensation expense, employee severance, and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative headcount, and legal and other administrative fees. General and administrative expenses decreased primarily due to a reduction in legal charges, as discussed under Corporate-Level Activity above, and employee severance, partially offset by an increase in headcount-related expenses.

OTHER INCOME AND INCOME TAXES

Other Income

The components of other income were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Dividends and interest income	**$ 205**	$ 197	**$ 415**	$ 400
Interest expense	**(72)**	(38)	**(117)**	(76)
Net recognized gains on investments	**118**	92	**152**	162
Net gains on derivatives	**108**	96	**103**	92
Net gains (losses) on foreign currency remeasurements	**(27)**	(23)	**(69)**	32
Other	**0**	46	**(38)**	43
Total	**$ 332**	$ 370	**$ 446**	$ 653

Dividends and interest income increased slightly due to higher average portfolio investment balances, offset in part by lower yields on our fixed-income investments. Interest expense increased due to our increased issuance of debt. Net recognized gains on investments increased in the three months ended December 31, 2010 due primarily to higher gains on sales of equity securities and were relatively consistent in the six months ended December 31, 2010 as compared to the prior period. Net gains on derivatives increased in both the three months and six months ended December 31, 2010 due primarily to higher gains on commodity and interest rate derivatives offset in part by higher losses on currency contracts used to hedge foreign currency revenues. Year-over-year changes in foreign currency remeasurements were primarily due to currency movements net of our hedging activities. Other includes a gain on the divestiture of Razorfish in the prior year periods.

Income Taxes

Our effective tax rates were approximately 22% and 25% for the three months ended December 31, 2010 and 2009, respectively, as compared to 23% and 25% for the six months ended December 31, 2010 and 2009, respectively. The reduction in the tax rate was due to the higher mix of earnings taxed at lower rates in foreign jurisdictions and from the retroactive extension of the research and development tax credit in the United States.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $41.3 billion as of December 31, 2010, compared with $36.8 billion as of June 30, 2010. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of investment grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities in order to diversify risk. Equity and other investments were $10.0 billion as of December 31, 2010, compared with $7.8 billion as of June 30, 2010.

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While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of December 31, 2010 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of our mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was $1.4 billion as of December 31, 2010. Our average and maximum securities lending payable balances for the three months ended December 31, 2010 were $2.1 billion and $3.3 billion, respectively. Our average and maximum securities lending payable balances for the six months ended December 31, 2010 were $1.9 billion and $3.3 billion, respectively. Intra-quarter variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

Valuation

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

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

Debt

Short-term Debt

During the three months ended December 31, 2010, we repaid $1.0 billion of commercial paper, leaving zero outstanding.

On November 5, 2010, our $1.0 billion 364-day credit facility expired. This facility served as a back-up for our commercial paper program. No amounts were drawn against the credit facility during any of the periods presented.

Long-term Debt

Notes

As of December 31, 2010, we had issued and outstanding $8.5 billion of debt securities as follows: $1.0 billion aggregate principal amount of 0.875% notes due 2013, $2.0 billion aggregate principal amount of 2.95% notes due 2014, $1.75 billion aggregate principal amount of 1.625% notes due 2015, $1.0 billion aggregate principal amount of

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4.20% notes due 2019, $1.0 billion aggregate principal amount of 3.0% notes due 2020, $750 million aggregate principal amount of 5.20% notes due 2039, and $1.0 billion aggregate principal amount of 4.5% notes due 2040, (collectively the Notes). The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Each $1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share.

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

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

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

Unearned Revenue

Unearned revenue at December 31, 2010 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each billing coverage period and accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at December 31, 2010 also included payments for: post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions; Microsoft Dynamics business solutions products; unspecified upgrades/enhancements of Windows Phone and Microsoft Internet Explorer on a when-and-if-available basis for Windows XP; 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 December 31, 2010:

(In millions)

Three Months Ending,	
March 31, 2011	$ 5,453
June 30, 2011	3,680
September 30, 2011	1,907
December 31, 2011	1,023
Thereafter	1,354

Total	$ 13,417

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Cash Flows

Cash flows from operations increased $1.3 billion to $12.4 billion for the six months ended December 31, 2010 due mainly to increased revenue and cash collections. Cash used for financing increased $923 million to $7.4 billion due mainly to a $4.0 billion increase in cash used for common stock repurchases, offset in part by a $3.0 billion increase in proceeds from issuances of debt. Cash used in investing increased $5.2 billion to $6.5 billion due mainly to a $6.4 billion decrease in sales and maturities of investments, partially offset by a $1.4 billion decrease in purchases of investments.

Share Repurchases

During the three months and six months ended December 31, 2010, we repurchased approximately 188 million and 351 million shares of Microsoft common stock for $5.0 billion and $9.0 billion, respectively, under the repurchase plan we announced on September 22, 2008. All repurchases were made using cash resources. As of December 31, 2010, approximately $14.7 billion remained of the $40.0 billion approved repurchase amount. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

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

Declaration Date	Per Share Dividend	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal year 2011				
September 21, 2010	**$ 0.16**	**November 18, 2010**	**$ 1,363**	**December 9, 2010**
December 15, 2010	**$ 0.16**	**February 17, 2011**	**$ 1,344**	**March 10, 2011**
Fiscal year 2010				
September 18, 2009	$ 0.13	November 19, 2009	$ 1,152	December 10, 2009
December 9, 2009	$ 0.13	February 18, 2010	$ 1,139	March 11, 2010

Off-Balance Sheet Arrangements

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. In evaluating estimated losses on these indemnifications, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. To date, we have not encountered significant costs as a result of these obligations and have not accrued any liabilities related to these indemnifications in our financial statements.

Other Planned Uses of Capital

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

We believe existing cash, cash equivalents, and short-term investments, together with funds generated from operations, should be sufficient to meet operating requirements, regular quarterly dividends, debt repayment schedules, and share repurchases. Our philosophy regarding the maintenance of a balance sheet with a large component of cash and cash equivalents, short-term investments, and equity and other investments, reflects our views on potential future capital requirements relating to research and development, creation and expansion of sales distribution channels, investments and acquisitions, share dilution management, legal risks, and challenges to our business model. We regularly assess our investment management approach in view of our current and potential future needs. We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. While we currently do not foresee a need to repatriate funds, should we require more capital in the U.S. than is generated by our operations locally, we could elect to repatriate funds held in foreign jurisdictions or raise capital in the U.S. through debt or equity issuances. These alternatives could result in higher effective tax rates or increased interest expense.

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As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was $13.2 billion at December 31, 2010. Our retained deficit is not expected to affect our future ability to operate, pay dividends, or repay our debt given our continuing profitability and strong cash and financial position.

RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

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

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

Recent Accounting Guidance Not Yet Adopted

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

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

Revenue Recognition

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

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Impairment of Investment Securities

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

Goodwill

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

Research and Development Costs

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

Legal and Other Contingencies

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

Income Taxes

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

recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a

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position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting literature also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial statements.

Stock-Based Compensation

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

Product Warranties

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

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

Foreign Currency

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

Interest Rate

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

Equity

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

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Commodity

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

VALUE-AT-RISK

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

The VaR is calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, and legal risk. The following table sets forth the one-day VaR for substantially all of our positions as of December 31, 2010 and June 30, 2010 and for the three months ended December 31, 2010:

(In millions)

			Three Months Ended December 31, 2010		
Risk Categories	**December 31, 2010**	**June 30, 2010**	**Average**	**High**	**Low**
Foreign currency	**$ 46**	$ 57	**$ 50**	**$ 57**	**$ 41**
Interest rate	**$ 53**	$ 58	**$ 54**	**$ 57**	**$ 51**
Equity	**$ 215**	$ 183	**$ 211**	**$ 216**	**$ 204**
Commodity	**$ 21**	$ 19	**$ 20**	**$ 21**	**$ 18**

Total one-day VaR for the combined risk categories was $266 million at December 31, 2010 and $235 million at June 30, 2010. The total VaR is 21% less at December 31, 2010, and 26% less at June 30, 2010, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 14 Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding certain legal proceedings in which we are involved.

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PART II

Item 1A

ITEM 1A. RISK FACTORS

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

The cloud-based computing model presents execution and competitive risks. We are transitioning to a computing environment characterized by cloud-based services used with smart client devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud. We are devoting significant resources to develop and deploy our own competing cloud-based software plus services strategies. While we believe our expertise, investments in infrastructure, and the breadth of our cloud-based services provides us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

- continuing to innovate and bring to market compelling cloud-based experiences that generate increasing traffic and market share;
- maintaining the utility, compatibility and performance of our cloud-based services on the growing array of computing devices, including smartphones, handheld computers, netbooks, tablets and television set top devices; and
- continuing to enhance the attractiveness of our cloud platforms to third-party developers.

Challenges to our business models may reduce our revenues or operating margins. Whether our software runs in the cloud or on a device, we continue to face challenges from alternative means of developing and licensing software. Under our license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. Certain open source software business models challenge our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not bear the full costs of research and development for the software. In some cases, their products may infringe patents granted to Microsoft for our inventions. In addition, advertising-based business models seek revenue by delivering third party advertisements to end customers who receive the software and services at no direct costs. Gains in market acceptance of open source or advertising based software may adversely affect our sales, revenue, and operating margins.

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

We derive substantial revenue from licenses of Windows operating systems on personal computers. It is uncertain to what extent alternative devices and form factors will increase the number of computing devices that users own or will substitute for users personal computer purchases. Alternative devices also run operating systems and applications developed by our competitors. These factors could impact our revenues and margins.

We face intense competition. We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio is a competitive advantage, our competitors that are focused on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products, in some cases in violation of our intellectual property rights or

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on the basis of technical specifications for Microsoft technologies that we make available at little or no cost in connection with our interoperability initiatives. In response to competition, we continue to develop versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins, and operating income.

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

Third parties may claim we infringe their intellectual property rights. From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. To resolve these claims we may enter into royalty and licensing agreements on less favorable terms, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

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

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

- engineering more secure products and services;
- enhancing security and reliability features in our products and services;
- helping our customers make the best use of our products and services to protect against computer viruses and other attacks;
- improving the deployment of software updates to address security vulnerabilities;

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

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

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, if third parties gain access to our networks or data centers they could obtain and exploit confidential business information and harm our competitive position. Finally, actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges.

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

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

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

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints include limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. We believe we are in full compliance with these rules. However, if we fail to comply with them, additional restrictions could be imposed on us that would adversely affect our business.

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

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

- We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail a delay in a product release and

removing functionality that customers want or on which developers rely.

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

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

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

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

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

We make significant investments in new products and services that may not be profitable. Our growth depends on our ability to innovate by offering new, and adding value to our existing, software and service offerings. We will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, Zune, Windows Live, the Windows Azure Services platform, and other cloud-based services offerings, and Xbox 360. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Our degree of success with Windows Phone, for example, will impact our ability to grow share of the smartphone operating system market. It will also be an important factor in supporting our strategy of delivering value to end users seamlessly over PC, phone, and TV device classes. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

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

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or

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

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

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

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

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

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the United States and other countries. Operations outside the United States may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region and difficulties in staffing and managing foreign operations may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability

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to conduct normal business operations and our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers. The long-term effects of climate change on the global economy in general or the information technology industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services. New regulations may require us to find alternative compliant and cost-effective methods of distributing our products and services.

Acquisitions and joint ventures may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don t realize a satisfactory return on our investment, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management s attention from our other businesses. These events could harm our operating results or financial condition.

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

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

(c) STOCK REPURCHASES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs
				(in millions)
October 1, 2010 October 31, 2010	8,379,000	$ 23.89	8,379,000	$ 19,478
November 1, 2010 November 30, 2010	95,054,845	$ 26.09	95,054,845	$ 16,998
December 1, 2010 December 31, 2010	84,722,465	$ 27.39	84,722,465	$ 14,678
	188,156,310		188,156,310	

During the second quarter of fiscal year 2011, we repurchased 188.2 million shares of Microsoft common stock for $5.0 billion using cash resources. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of December 31, 2010, approximately $14.7 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

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ITEM 6. EXHIBITS

12	Computation of Ratio of Earnings to Fixed Charges
15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase
101.DEF**	XBRL Taxonomy Extension Definition Linkbase
101.LAB**	XBRL Taxonomy Extension Label Linkbase
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase

* *Furnished, not filed.*

** *Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.*

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

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SIGNATURE

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

MICROSOFT CORPORATION

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

Chief Accounting Officer (Duly Authorized Officer)
January 27, 2011