MICROSOFT CORP
Form 10-Q
January 26, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended December 31, 2016

OR

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

Commission File Number: 001-37845

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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 20, 2017
Common Stock, $0.00000625 par value per share	7,727,529,820 shares

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2016

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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,	
	2016	2015	2016	2015
Revenue:				
Product	$ 16,537	$17,974	$ 30,030	$ 33,193
Service and other	7,553	5,822	14,513	10,982
Total revenue	24,090	23,796	44,543	44,175
Cost of revenue:				
Product	5,378	6,268	8,959	10,303
Service and other	4,523	3,604	8,786	6,776
Total cost of revenue	9,901	9,872	17,745	17,079
Gross margin	14,189	13,924	26,798	27,096
Research and development	3,062	2,900	6,168	5,862
Sales and marketing	4,071	3,960	7,304	7,293
General and administrative	879	1,038	1,924	2,122
Operating income	6,177	6,026	11,402	11,819
Other income (expense), net	186	(171)	286	(451)
Income before income taxes	6,363	5,855	11,688	11,368
Provision for income taxes	1,163	837	1,798	1,448
Net income	$5,200	$5,018	$9,890	$9,920

Earnings per share:				
Basic	$0.67	$0.63	$1.27	$1.24
Diluted	$0.66	$0.62	$1.26	$1.23
Weighted average shares outstanding:				
Basic	7,755	7,964	7,772	7,980
Diluted	7,830	8,051	7,853	8,068
Cash dividends declared per common share	$0.39	$0.36	$0.78	$0.72

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Net income	$ 5,200	$ 5,018	$ 9,890	$ 9,920
Other comprehensive income (loss):				
Net unrealized gains (losses) on derivatives (net of tax effects of $0, $5, $(2), and $28)	280	(49)	243	8
Net unrealized gains (losses) on investments (net of tax effects of $(535), $86, $(491), and $(222))	(994)	160	(911)	(411)
Translation adjustments and other (net of tax effects of $0, $(9), $7, and $(21))	(455)	(76)	(357)	(346)
Other comprehensive income (loss)	(1,169)	35	(1,025)	(749)
Comprehensive income	$ 4,031	$ 5,053	$ 8,865	$ 9,171

See accompanying notes.

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BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2016	June 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	$8,468	$6,510
Short-term investments (including securities loaned of $1,230 and $204)	114,313	106,730
Total cash, cash equivalents, and short-term investments	122,781	113,240
Accounts receivable, net of allowance for doubtful accounts of $340 and $426	14,343	18,277
Inventories	1,961	2,251
Other	5,864	5,892
Total current assets	144,949	139,660
Property and equipment, net of accumulated depreciation of $21,888 and $19,800	21,379	18,356
Equity and other investments	8,912	10,431
Goodwill	34,524	17,872
Intangible assets, net	11,001	3,733
Other long-term assets	3,845	3,416
Total assets	$ 224,610	$ 193,468
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$6,580	$6,898
Short-term debt	25,065	12,904
Current portion of long-term debt	599	0
Accrued compensation	3,982	5,264
Income taxes	508	580
Short-term unearned revenue	26,085	27,468
Securities lending payable	1,280	294
Other	6,688	5,949
Total current liabilities	70,787	59,357

Long-term debt	59,306	40,557
Long-term unearned revenue	8,595	6,441
Deferred income taxes	1,133	1,476
Other long-term liabilities	15,980	13,640
Total liabilities	155,801	121,471
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital—shares authorized 24,000; outstanding 7,730 and 7,808	68,177	68,178
Retained earnings	120	2,282
Accumulated other comprehensive income	512	1,537
Total stockholders' equity	68,809	71,997
Total liabilities and stockholders' equity	$224,610	$193,468

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Operations				
Net income	$5,200	$5,018	$9,890	$9,920
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	2,166	1,544	3,982	3,005
Stock-based compensation expense	767	658	1,470	1,332
Net recognized losses (gains) on investments and derivatives	(652)	50	(963)	151
Deferred income taxes	(587)	(247)	(572)	(174)
Deferral of unearned revenue	14,141	12,570	26,724	22,993
Recognition of unearned revenue	(13,645)	(11,929)	(26,549)	(23,284)
Changes in operating assets and liabilities:				
Accounts receivable	(2,711)	(3,118)	4,463	3,258
Inventories	1,132	1,104	265	167
Other current assets	1,309	(932)	343	(1,494)
Other long-term assets	(243)	56	(272)	51
Accounts payable	99	369	(344)	234
Other current liabilities	(1,529)	105	(1,890)	(1,919)
Other long-term liabilities	846	370	1,295	254
Net cash from operations	6,293	5,618	17,842	14,494
Financing				
Repayments of short-term debt, maturities of 90 days or less, net	(3,755)	(7,031)	(7,145)	(2,141)
Proceeds from issuance of debt	17,069	13,128	42,046	13,249
Repayments of debt	(4,118)	(121)	(4,343)	(1,871)
Common stock issued	131	117	372	336
Common stock repurchased	(3,599)	(3,678)	(7,961)	(8,435)
Common stock cash dividends paid	(3,024)	(2,868)	(5,824)	(5,343)
Other	312	(65)	200	(243)
Net cash from (used in) financing	3,016	(518)	17,345	(4,448)
Investing				

Additions to property and equipment	(1,988)	(2,024)	(4,151)	(3,380)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	(24,760)	(381)	(24,784)	(771)
Purchases of investments	(46,775)	(34,750)	(103,956)	(72,320)
Maturities of investments	8,715	5,351	17,374	11,037
Sales of investments	48,987	28,191	81,310	56,693
Securities lending payable	1,070	285	986	347
Net cash used in investing	(14,751)	(3,328)	(33,221)	(8,394)
Effect of foreign exchange rates on cash and cash equivalents	(18)	(18)	(8)	(62)
Net change in cash and cash equivalents	(5,460)	1,754	1,958	1,590
Cash and cash equivalents, beginning of period	13,928	5,431	6,510	5,595
Cash and cash equivalents, end of period	$8,468	$7,185	$8,468	$7,185

See accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Common stock and paid-in capital				
Balance, beginning of period	$67,747	$67,811	$68,178	$68,465
Common stock issued	131	117	372	336
Common stock repurchased	(561)	(609)	(1,935)	(2,157)
Stock-based compensation expense	767	658	1,470	1,332
Other, net	93	0	92	1
Balance, end of period	68,177	67,977	68,177	67,977
Retained earnings				
Balance, beginning of period	944	7,896	2,282	9,096
Net income	5,200	5,018	9,890	9,920
Common stock cash dividends	(3,003)	(2,846)	(6,028)	(5,708)
Common stock repurchased	(3,021)	(3,038)	(6,024)	(6,278)
Balance, end of period	120	7,030	120	7,030
Accumulated other comprehensive income				
Balance, beginning of period	1,681	1,738	1,537	2,522
Other comprehensive income (loss)	(1,169)	35	(1,025)	(749)
Balance, end of period	512	1,773	512	1,773
Total stockholders' equity	$ 68,809	$ 76,780	$ 68,809	$ 76,780

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 — ACCOUNTING POLICIES

Accounting Principles

We prepare our unaudited interim consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair presentation of the results for the interim periods presented. 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 2016 Form 10-K filed with the U.S. Securities and Exchange Commission on July 28, 2016.

We have recast certain prior period amounts to conform to the current period presentation, with no impact on consolidated net income or cash flows.

Principles of Consolidation

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

Estimates and Assumptions

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

Product Revenue and Service and Other Revenue

Product revenue includes sales from operating systems; cross-device productivity applications; server applications; business solution applications; desktop and server management tools; software development tools; video games;

hardware such as PCs, tablets, gaming and entertainment consoles, phones, other intelligent devices, and related accessories; and training and certification of computer system integrators and developers.

Service and other revenue includes sales from cloud-based solutions that provide customers with software, services, platforms, and content such as Office 365, Microsoft Azure (“Azure”), Microsoft Dynamics 365 (“Dynamics 365”), and Xbox Live; solution support; and consulting services. Service and other revenue also includes sales from online advertising and LinkedIn.

Recent Accounting Guidance Not Yet Adopted

Financial Instruments – Credit Losses

In June 2016, the Financial Accounting Standards Board (“FASB”) issued a new standard to replace the incurred loss impairment methodology in current U.S. GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For trade and other receivables, loans, and other financial instruments, we will be required to use a forward-looking expected

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loss model rather than the incurred loss model for recognizing credit losses which reflects losses that are probable. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. The new standard will be effective for us beginning July 1, 2020, with early adoption permitted beginning July 1, 2019. Application of the amendments is through a cumulative-effect adjustment to retained earnings as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements.

Leases

In February 2016, the FASB issued a new standard related to leases to increase transparency and comparability among organizations by requiring the recognition of lease assets and lease liabilities on the balance sheet. Most prominent among the amendments is the recognition of assets and liabilities by lessees for those leases classified as operating leases under previous U.S. GAAP. Under the new standard, disclosures are required to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We will be required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach.

The new standard will be effective for us beginning July 1, 2019, with early adoption permitted. We currently anticipate early adoption of the new standard effective July 1, 2017 in conjunction with our adoption of the new revenue standard. Our ability to early adopt is dependent on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior period financial statements. We remain on schedule and have implemented specific system functionality to enable the accounting transition.

We anticipate this standard will have a material impact on our consolidated balance sheets. However, we do not believe adoption will have a material impact on our consolidated income statements. Due to the recent acquisition of LinkedIn Corporation (“LinkedIn”), we are still assessing the qualitative and quantitative impacts of the leases assumed on our consolidated balance sheets. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting for office space, retail space, and datacenter operating leases. We expect our accounting for capital leases related to office space and datacenters will remain substantially unchanged under the new standard.

Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

In January 2016, the FASB issued a new standard to amend certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the amendments is the requirement for changes in the fair value of our equity investments, with certain exceptions, to be recognized through net income rather than other comprehensive income (“OCI”). The new standard will be effective for us beginning July 1, 2018. The application of the amendments will result in a cumulative-effect adjustment to our consolidated balance sheets as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements.

Revenue from Contracts with Customers

In May 2014, the FASB issued a new standard related to revenue recognition. Under the new standard, revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The FASB recently issued several amendments to the standard, including clarifications on disclosure of prior-period performance obligations and remaining performance obligations.

The guidance permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the cumulative catch-up transition method). We currently anticipate adopting the standard using the full retrospective method to restate each prior reporting period presented.

The new standard will be effective for us beginning July 1, 2018, and adoption as of the original effective date of July 1, 2017 is permitted. We currently anticipate early adoption of the new standard effective July 1, 2017. While our ability to early adopt using the full retrospective method is dependent on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior

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period financial statements, we remain on schedule and have implemented key system functionality to enable restated financial information. Our progress includes nearing completion of retrospectively adjusted financial information for fiscal year 2016.

We anticipate this standard will have a material impact on our consolidated financial statements, and continue to make progress in assessing all potential impacts of the standard, including any impacts from recently issued amendments. We have reached conclusions on all key accounting assessments related to the new standard. However, we are still assessing impacts from guidance issued by the FASB Transition Resource Group as part of their November 2016 meeting. We will continue to monitor and assess the impact of changes to the standard and interpretations as they become available. We have also started our assessment to determine the revenue recognition impact of our recent acquisition of LinkedIn. The most significant impact of the standard relates to our accounting for software license revenue. Specifically, under the new standard we expect to recognize Windows 10 revenue predominantly at the time of billing rather than ratably over the life of the related device. We expect to recognize license revenue at the time of contract execution rather than over the subscription period from certain multi-year commercial software subscriptions that include both software licenses and Software Assurance. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard will be dependent on contract-specific terms, and may vary in some instances from recognition at the time of billing. We expect revenue recognition related to our hardware, cloud offerings including Office 365, and professional services to remain substantially unchanged.

We continue to believe that the net change in Windows 10 revenue from period to period is indicative of the net change in revenue we expect from the adoption of the new standard.

NOTE 2 — EARNINGS PER SHARE

Basic earnings per share (“EPS”) is computed based on the weighted average number of shares of common stock outstanding during the period. Diluted EPS is computed based on the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and stock awards.

The components of basic and diluted EPS were as follows:

	Three Months Ended		Six Months Ended	
(In millions, except earnings per share)	December 31,		December 31,	
	2016	2015	2016	2015
Net income available for common shareholders (A)	$ 5,200	$ 5,018	$ 9,890	$ 9,920

Weighted average outstanding shares of common stock (B)	7,755	7,964	7,772	7,980
Dilutive effect of stock-based awards	75	87	81	88
Common stock and common stock equivalents (C)	7,830	8,051	7,853	8,068
Earnings Per Share				
Basic (A/B)	$ 0.67	$ 0.63	$ 1.27	$ 1.24
Diluted (A/C)	$ 0.66	$ 0.62	$ 1.26	$ 1.23

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

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NOTE 3 — OTHER INCOME (EXPENSE), NET

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Dividends and interest income	$ 311	$ 200	$ 604	$ 399
Interest expense	(521)	(309)	(958)	(558)
Net recognized gains on investments	698	106	1,103	108
Net losses on derivatives	(46)	(156)	(140)	(259)
Net gains (losses) on foreign currency remeasurements	(82)	2	(134)	(34)
Other	(174)	(14)	(189)	(107)
Total	$ 186	$ (171)	$ 286	$ (451)

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Other-than-temporary impairments of investments	$ (21)	$ (127)	$ (39)	$ (162)
Realized gains from sales of available-for-sale securities	851	351	1,334	458
Realized losses from sales of available-for-sale securities	(132)	(118)	(192)	(188)
Total	$ 698	$ 106	$ 1,103	$ 108

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NOTE 4 — INVESTMENTS

Investment Components

The components of investments, including associated derivatives, but excluding held-to-maturity investments, 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, 2016							
Cash	$4,037	$ 0	$ 0	$4,037	$ 4,037	$ 0	$ 0
Mutual funds	2,363	0	0	2,363	1,961	402	0
Commercial paper	177	0	0	177	77	100	0
Certificates of deposit	1,284	0	0	1,284	1,098	186	0
U.S. government and agency securities	100,128	27	(415)	99,740	1,052	98,688	0
Foreign government bonds	4,747	3	(29)	4,721	243	4,478	0
Mortgage- and asset-backed securities	4,361	12	(7)	4,366	0	4,366	0
Corporate notes and bonds	5,736	64	(26)	5,774	0	5,774	0
Municipal securities	283	39	0	322	0	322	0
Common and preferred stock	4,864	3,685	(160)	8,389	0	0	8,389
Other investments	494	0	0	494	0	(3)	497
Total	$ 128,474	$ 3,830	$ (637)	$ 131,667	$ 8,468	$ 114,313	$ 8,886

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(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments