**ESPRESSO SOFTWARE**

**FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**INCOME STATEMENTS**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except per share amounts)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Revenue |  | **$** | **62,484** |  |  | $ | 58,437 |  |  | $ | 60,420 |  |
| Operating expenses: |  |  |  |  |  |  |  |  |  |  |  |  |
| Cost of revenue |  |  | **12,395** |  |  |  | 12,155 |  |  |  | 11,598 |  |
| Research and development |  |  | **8,714** |  |  |  | 9,010 |  |  |  | 8,164 |  |
| Sales and marketing |  |  | **13,214** |  |  |  | 12,879 |  |  |  | 13,260 |  |
| General and administrative |  |  | **4,004** |  |  |  | 3,700 |  |  |  | 5,127 |  |
| Employee severance |  |  | **59** |  |  |  | 330 |  |  |  | 0 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total operating expenses |  |  | **38,386** |  |  |  | 38,074 |  |  |  | 38,149 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Operating income |  |  | **24,098** |  |  |  | 20,363 |  |  |  | 22,271 |  |
| Other income (expense) |  |  | **915** |  |  |  | (542 | ) |  |  | 1,543 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Income before income taxes |  |  | **25,013** |  |  |  | 19,821 |  |  |  | 23,814 |  |
| Provision for income taxes |  |  | **6,253** |  |  |  | 5,252 |  |  |  | 6,133 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net income |  | **$** | **18,760** |  |  | $ | 14,569 |  |  | $ | 17,681 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |
| Earnings per share: |  |  |  |  |  |  |  |  |  |  |  |  |
| Basic |  | **$** | **2.13** |  |  | $ | 1.63 |  |  | $ | 1.90 |  |
| Diluted |  | **$** | **2.10** |  |  | $ | 1.62 |  |  | $ | 1.87 |  |
|  |  | | | |  | | | |  | | | |
| Weighted average shares outstanding: |  |  |  |  |  |  |  |  |  |  |  |  |
| Basic |  |  | **8,813** |  |  |  | 8,945 |  |  |  | 9,328 |  |
| Diluted |  |  | **8,927** |  |  |  | 8,996 |  |  |  | 9,470 |  |
|  |  | | | |  | | | |  | | | |
| Cash dividends declared per common share |  | **$** | **0.52** |  |  | $ | 0.52 |  |  | $ | 0.44 |  |

See accompanying notes.

**BALANCE SHEETS**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| **Assets** |  |  |  |  |  |  |  |  |
| Current assets: |  |  |  |  |  |  |  |  |
| Cash and cash equivalents |  | **$** | **5,505** |  |  | $ | 6,076 |  |
| Short-term investments (including securities loaned of **$62** and $1,540) |  |  | **31,283** |  |  |  | 25,371 |  |
|  | | | |  |  |  |  |  |
| Total cash, cash equivalents, and short-term investments |  |  | **36,788** |  |  |  | 31,447 |  |
| Accounts receivable, net of allowance for doubtful accounts of **$375** and $451 |  |  | **13,014** |  |  |  | 11,192 |  |
| Inventories |  |  | **740** |  |  |  | 717 |  |
| Deferred income taxes |  |  | **2,184** |  |  |  | 2,213 |  |
| Other |  |  | **2,950** |  |  |  | 3,711 |  |
|  | | | |  |  |  |  |  |
| Total current assets |  |  | **55,676** |  |  |  | 49,280 |  |
| Property and equipment, net of accumulated depreciation of **$8,629** and $7,547 |  |  | **7,630** |  |  |  | 7,535 |  |
| Equity and other investments |  |  | **7,754** |  |  |  | 4,933 |  |
| Goodwill |  |  | **12,394** |  |  |  | 12,503 |  |
| Intangible assets, net |  |  | **1,158** |  |  |  | 1,759 |  |
| Deferred income taxes |  |  | **0** |  |  |  | 279 |  |
| Other long-term assets |  |  | **1,501** |  |  |  | 1,599 |  |
|  | | | |  |  |  |  |  |
| Total assets |  | **$** | **86,113** |  |  | $ | 77,888 |  |
|  |  |  |  |  |  |  |  |  |
| **Liabilities and stockholders’ equity** |  |  |  |  |  |  |  |  |
| Current liabilities: |  |  |  |  |  |  |  |  |
| Accounts payable |  | **$** | **4,025** |  |  | $ | 3,324 |  |
| Short-term debt |  |  | **1,000** |  |  |  | 2,000 |  |
| Accrued compensation |  |  | **3,283** |  |  |  | 3,156 |  |
| Income taxes |  |  | **1,074** |  |  |  | 725 |  |
| Short-term unearned revenue |  |  | **13,652** |  |  |  | 13,003 |  |
| Securities lending payable |  |  | **182** |  |  |  | 1,684 |  |
| Other |  |  | **2,931** |  |  |  | 3,142 |  |
|  | | | |  |  |  |  |  |
| Total current liabilities |  |  | **26,147** |  |  |  | 27,034 |  |
| Long-term debt |  |  | **4,939** |  |  |  | 3,746 |  |
| Long-term unearned revenue |  |  | **1,178** |  |  |  | 1,281 |  |
| Deferred income taxes |  |  | **229** |  |  |  | 0 |  |
| Other long-term liabilities |  |  | **7,445** |  |  |  | 6,269 |  |
| Commitments and contingencies |  |  |  |  |  |  |  |  |
| Stockholders’ equity: |  |  |  |  |  |  |  |  |
| Common stock and paid-in capital – shares authorized 24,000; outstanding **8,668** and 8,908 |  |  | **62,856** |  |  |  | 62,382 |  |
| Retained deficit, including accumulated other comprehensive income of **$1,055** and $969 |  |  | **(16,681** | **)** |  |  | (22,824 | ) |
|  | | | |  |  |  |  |  |
| Total stockholders’ equity |  |  | **46,175** |  |  |  | 39,558 |  |
|  | | | |  |  |  |  |  |
| Total liabilities and stockholders’ equity |  | **$** | **86,113** |  |  | $ | 77,888 |  |
|  |  |  |  |  |  |  |  |  |

See accompanying notes.

**CASH FLOWS STATEMENTS**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| **Operations** |  |  |  |  |  |  |  |  |  |  |  |  |
| Net income |  | **$** | **18,760** |  |  | $ | 14,569 |  |  | $ | 17,681 |  |
| Adjustments to reconcile net income to net cash from operations: |  |  |  |  |  |  |  |  |  |  |  |  |
| Depreciation, amortization, and other noncash items |  |  | **2,673** |  |  |  | 2,562 |  |  |  | 2,056 |  |
| Stock-based compensation |  |  | **1,891** |  |  |  | 1,708 |  |  |  | 1,479 |  |
| Net recognized losses (gains) on investments and derivatives |  |  | **(208** | **)** |  |  | 683 |  |  |  | (572 | ) |
| Excess tax benefits from stock-based compensation |  |  | **(45** | **)** |  |  | (52 | ) |  |  | (120 | ) |
| Deferred income taxes |  |  | **(220** | **)** |  |  | 762 |  |  |  | 935 |  |
| Deferral of revenue |  |  | **29,374** |  |  |  | 24,409 |  |  |  | 24,532 |  |
| Recognition of unearned revenue |  |  | **(28,813** | **)** |  |  | (25,426 | ) |  |  | (21,944 | ) |
| Changes in operating assets and liabilities: |  |  |  |  |  |  |  |  |  |  |  |  |
| Accounts receivable |  |  | **(2,238** | **)** |  |  | 2,215 |  |  |  | (1,569 | ) |
| Other current assets |  |  | **420** |  |  |  | (422 | ) |  |  | 153 |  |
| Other long-term assets |  |  | **(223** | **)** |  |  | (273 | ) |  |  | (98 | ) |
| Other current liabilities |  |  | **1,295** |  |  |  | (3,371 | ) |  |  | (748 | ) |
| Other long-term liabilities |  |  | **1,407** |  |  |  | 1,673 |  |  |  | (173 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net cash from operations |  |  | **24,073** |  |  |  | 19,037 |  |  |  | 21,612 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| **Financing** |  |  |  |  |  |  |  |  |  |  |  |  |
| Short-term borrowings (repayments), maturities of 90 days or less, net |  |  | **(991** | **)** |  |  | 1,178 |  |  |  | 0 |  |
| Proceeds from issuance of debt, maturities longer than 90 days |  |  | **4,167** |  |  |  | 4,796 |  |  |  | 0 |  |
| Repayments of debt, maturities longer than 90 days |  |  | **(2,986** | **)** |  |  | (228 | ) |  |  | 0 |  |
| Common stock issued |  |  | **2,311** |  |  |  | 579 |  |  |  | 3,494 |  |
| Common stock repurchased |  |  | **(11,269** | **)** |  |  | (9,353 | ) |  |  | (12,533 | ) |
| Common stock cash dividends paid |  |  | **(4,578** | **)** |  |  | (4,468 | ) |  |  | (4,015 | ) |
| Excess tax benefits from stock-based compensation |  |  | **45** |  |  |  | 52 |  |  |  | 120 |  |
| Other |  |  | **10** |  |  |  | (19 | ) |  |  | 0 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net cash used in financing |  |  | **(13,291** | **)** |  |  | (7,463 | ) |  |  | (12,934 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| **Investing** |  |  |  |  |  |  |  |  |  |  |  |  |
| Additions to property and equipment |  |  | **(1,977** | **)** |  |  | (3,119 | ) |  |  | (3,182 | ) |
| Acquisition of companies, net of cash acquired |  |  | **(245** | **)** |  |  | (868 | ) |  |  | (8,053 | ) |
| Purchases of investments |  |  | **(30,168** | **)** |  |  | (36,850 | ) |  |  | (20,954 | ) |
| Maturities of investments |  |  | **7,453** |  |  |  | 6,191 |  |  |  | 2,597 |  |
| Sales of investments |  |  | **15,125** |  |  |  | 19,806 |  |  |  | 25,132 |  |
| Securities lending payable |  |  | **(1,502** | **)** |  |  | (930 | ) |  |  | (127 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net cash used in investing |  |  | **(11,314** | **)** |  |  | (15,770 | ) |  |  | (4,587 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Effect of exchange rates on cash and cash equivalents |  |  | **(39** | **)** |  |  | (67 | ) |  |  | 137 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net change in cash and cash equivalents |  |  | **(571** | **)** |  |  | (4,263 | ) |  |  | 4,228 |  |
| Cash and cash equivalents, beginning of period |  |  | **6,076** |  |  |  | 10,339 |  |  |  | 6,111 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Cash and cash equivalents, end of period |  | **$** | **5,505** |  |  | $ | 6,076 |  |  | $ | 10,339 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

See accompanying notes.

**STOCKHOLDERS’ EQUITY STATEMENTS**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| **Common stock and paid-in capital** |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance, beginning of period |  | **$** | **62,382** |  |  | $ | 62,849 |  |  | $ | 60,557 |  |
| Common stock issued |  |  | **2,311** |  |  |  | 567 |  |  |  | 3,504 |  |
| Common stock repurchased |  |  | **(3,113** | **)** |  |  | (2,611 | ) |  |  | (3,022 | ) |
| Stock-based compensation expense |  |  | **1,891** |  |  |  | 1,708 |  |  |  | 1,479 |  |
| Stock-based compensation income tax benefits (deficiencies) |  |  | **(647** | **)** |  |  | (128 | ) |  |  | 253 |  |
| Other, net |  |  | **32** |  |  |  | (3 | ) |  |  | 78 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Balance, end of period |  |  | **62,856** |  |  |  | 62,382 |  |  |  | 62,849 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| **Retained deficit** |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance, beginning of period |  |  | **(22,824** | **)** |  |  | (26,563 | ) |  |  | (29,460 | ) |
| Cumulative effect of a change in accounting principle relating to uncertain tax positions |  |  | **0** |  |  |  | 0 |  |  |  | (395 | ) |
| Cumulative effect of a change in accounting principle relating to costs of certain compensated absences |  |  | **0** |  |  |  | 0 |  |  |  | (17 | ) |
| Net income |  |  | **18,760** |  |  |  | 14,569 |  |  |  | 17,681 |  |
| Other comprehensive income: |  |  |  |  |  |  |  |  |  |  |  |  |
| Net unrealized gains on derivatives |  |  | **27** |  |  |  | 302 |  |  |  | 18 |  |
| Net unrealized gains (losses) on investments |  |  | **265** |  |  |  | (233 | ) |  |  | (653 | ) |
| Translation adjustments and other |  |  | **(206** | **)** |  |  | (240 | ) |  |  | 121 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Comprehensive income |  |  | **18,846** |  |  |  | 14,398 |  |  |  | 17,167 |  |
| Common stock cash dividends |  |  | **(4,547** | **)** |  |  | (4,620 | ) |  |  | (4,084 | ) |
| Common stock repurchased |  |  | **(8,156** | **)** |  |  | (6,039 | ) |  |  | (9,774 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Balance, end of period |  |  | **(16,681** | **)** |  |  | (22,824 | ) |  |  | (26,563 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total stockholders’ equity |  | **$** | **46,175** |  |  | $ | 39,558 |  |  | $ | 36,286 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

See accompanying notes.

**NOTES TO FINANCIAL STATEMENTS**

NOTE 1 — ACCOUNTING POLICIES

**Accounting Principles**

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

**Principles of Consolidation**

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

**Estimates and Assumptions**

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

**Foreign Currencies**

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

**Revenue Recognition**

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

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

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

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

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

**Cost of Revenue**

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

**Product Warranty**

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

**Research and Development**

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

**Sales and Marketing**

Sales and marketing expenses include payroll, employee benefits, stock-based compensation, and other headcount-related expenses associated with sales and marketing personnel, and the costs of advertising, promotions, trade shows, seminars, and other programs. Advertising costs are expensed as incurred. Advertising expense was $1.6 billion, $1.4 billion, and $1.2 billion in fiscal years 2018, 2017, and 2016, respectively.

**Employee Severance**

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

**Stock-Based Compensation**

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

**Employee Stock Purchase Plan**

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

**Income Taxes**

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

**Fair Value Measurements**

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

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

• *Level 2* – inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all 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.

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

**Financial Instruments**

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

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

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

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. Fair value is calculated based on publicly available market information or other estimates determined by management. We employ a systematic methodology on a quarterly basis that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established.

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

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

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

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

**Allowance for Doubtful Accounts**

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Balance, beginning of period |  | **$** | **451** |  |  | $ | 153 |  |  | $ | 117 |  |
| Charged to costs and other |  |  | **45** |  |  |  | 360 |  |  |  | 88 |  |
| Write-offs |  |  | **(121** | **)** |  |  | (62 | ) |  |  | (52 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Balance, end of period |  | **$** | **375** |  |  | $ | 451 |  |  | $ | 153 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

**Inventories**

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

**Property and Equipment**

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the lease term. The estimated useful lives of our property and equipment are generally as follows: computer software developed or acquired for internal use, three years; computer equipment, two to three years; buildings and improvements, five to 15 years; leasehold improvements, two to 10 years; and furniture and equipment, one to five years. Land is not depreciated.

**Goodwill**

Goodwill is tested for impairment using a fair-value-based approach on an annual basis (May 1 for us) and between annual tests if indicators of potential impairment exist.

**Intangible Assets**

All of our intangible assets are subject to amortization and are amortized using the straight-line method over their estimated period of benefit, ranging from one to 10 years. We evaluate the recoverability of intangible assets periodically by taking into account events or circumstances that may warrant revised estimates of useful lives or that indicate the asset may be impaired.

**Recently Issued Accounting Standards**

*Recently Adopted Accounting Pronouncements*

In January 2018, the Financial Accounting Standards Board (“FASB”) issued guidance to amend the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance became effective for us with the reporting period beginning January 1, 2018, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, adoption of this new guidance did not have a material impact on our financial statements. See Note 6 – Fair Value Measurements.

On July 1, 2017, we adopted guidance issued by the FASB on business combinations. The guidance retains the fundamental requirements that the acquisition method of accounting (previously referred to as the purchase method of accounting) be used for all business combinations, but requires a number of changes, including changes in the way assets and liabilities are recognized and measured as a result of business combinations. It also requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. We have applied this guidance to business combinations completed since July 1, 2017.

On July 1, 2017, we adopted guidance issued by the FASB that changes the accounting and reporting for non-controlling interests. Non-controlling interests are to be reported as a component of equity separate from the parent’s equity, and purchases or sales of equity interests that do not result in a change in control are to be accounted for as equity transactions. In addition, net income attributable to a non-controlling interest is to be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, is to be recorded at fair value with any gain or loss recognized in net income. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2017, we adopted guidance on fair value measurement for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Adoption of the new guidance did not have a material impact on our financial statements.

*Recent Accounting Pronouncements Not Yet Adopted*

In October 2017, the FASB issued guidance on revenue recognition that will become effective for us beginning July 1, 2018. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe adoption of this new guidance will not have a material impact on our financial statements.

In June 2017, the FASB issued guidance on the consolidation of variable interest entities, which is effective for us beginning July 1, 2018. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. We believe adoption of this new guidance will not have a material impact on our financial statements.

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)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Net income available for common shareholders (A) |  | **$** | **18,760** |  |  | $ | 14,569 |  |  | $ | 17,681 |  |
|  |  | | | |  | | | |  | | | |
| Weighted average outstanding shares of common stock (B) |  |  | **8,813** |  |  |  | 8,945 |  |  |  | 9,328 |  |
| Dilutive effect of stock-based awards |  |  | **114** |  |  |  | 51 |  |  |  | 142 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Common stock and common stock equivalents (C) |  |  | **8,927** |  |  |  | 8,996 |  |  |  | 9,470 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |
| **Earnings Per Share** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| Basic (A/B) |  | **$** | **2.13** |  |  | $ | 1.63 |  |  | $ | 1.90 |  |
| Diluted (A/C) |  | **$** | **2.10** |  |  | $ | 1.62 |  |  | $ | 1.87 |  |

For fiscal years 2018, 2017, and 2016, 28 million, 342 million, and 91 million shares, respectively, were attributable to outstanding stock-based awards and were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive.

In June 2018, 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 12 – Debt.

NOTE 3 — OTHER INCOME (EXPENSE)

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Dividends and interest income |  | **$** | **843** |  |  | $ | 744 |  |  | $ | 994 |  |
| Interest expense |  |  | **(151** | **)** |  |  | (38 | ) |  |  | (106 | ) |
| Net recognized gains (losses) on investments |  |  | **348** |  |  |  | (125 | ) |  |  | 346 |  |
| Net gains (losses) on derivatives |  |  | **(140** | **)** |  |  | (558 | ) |  |  | 226 |  |
| Net gains (losses) on foreign currency remeasurements |  |  | **1** |  |  |  | (509 | ) |  |  | 226 |  |
| Other |  |  | **14** |  |  |  | (56 | ) |  |  | (143 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **915** |  |  | $ | (542 | ) |  | $ | 1,543 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

Other-than-temporary impairments, which are included in net recognized gains (losses) on investments in the table above, were $69 million, $862 million, and $312 million in fiscal years 2018, 2017, and 2016, respectively. Realized gains and losses from sales of available-for-sale securities (excluding other-than-temporary impairments) were $605 million and $188 million, respectively, in fiscal year 2018, $1.6 billion and $897 million, respectively, in fiscal year 2017, and $751 million and $93 million, respectively, in fiscal year 2016.

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** | |  |
|  | | | | | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2018** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| 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** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Cost Basis** | |  |  | **Unrealized**  **Gains** | |  |  | **Unrealized**  **Losses** | |  |  | **Recorded**  **Basis** | |  |  | **Cash**  **and Cash**  **Equivalents** | |  |  | **Short-term**  **Investments** | |  |  | **Equity**  **and Other**  **Investments** | |  |
|  | | | | | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2017** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Cash |  | $ | 2,064 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 2,064 |  |  | $ | 2,064 |  |  | $ | 0 |  |  | $ | 0 |  |
| Mutual funds |  |  | 1,007 |  |  |  | 0 |  |  |  | (25 | ) |  |  | 982 |  |  |  | 900 |  |  |  | 82 |  |  |  | 0 |  |
| Commercial paper |  |  | 2,601 |  |  |  | 0 |  |  |  | 0 |  |  |  | 2,601 |  |  |  | 400 |  |  |  | 2,201 |  |  |  | 0 |  |
| Certificates of deposit |  |  | 555 |  |  |  | 0 |  |  |  | 0 |  |  |  | 555 |  |  |  | 275 |  |  |  | 280 |  |  |  | 0 |  |
| U.S. Government and Agency securities |  |  | 13,450 |  |  |  | 21 |  |  |  | (5 | ) |  |  | 13,466 |  |  |  | 2,369 |  |  |  | 11,097 |  |  |  | 0 |  |
| Foreign government bonds |  |  | 3,450 |  |  |  | 71 |  |  |  | (4 | ) |  |  | 3,517 |  |  |  | 0 |  |  |  | 3,517 |  |  |  | 0 |  |
| Mortgage-backed securities |  |  | 3,353 |  |  |  | 81 |  |  |  | (16 | ) |  |  | 3,418 |  |  |  | 0 |  |  |  | 3,418 |  |  |  | 0 |  |
| Corporate notes and bonds |  |  | 4,361 |  |  |  | 287 |  |  |  | (52 | ) |  |  | 4,596 |  |  |  | 0 |  |  |  | 4,596 |  |  |  | 0 |  |
| Municipal securities |  |  | 255 |  |  |  | 2 |  |  |  | (1 | ) |  |  | 256 |  |  |  | 68 |  |  |  | 188 |  |  |  | 0 |  |
| Common and preferred stock |  |  | 4,015 |  |  |  | 627 |  |  |  | (182 | ) |  |  | 4,460 |  |  |  | 0 |  |  |  | 0 |  |  |  | 4,460 |  |
| Other investments |  |  | 465 |  |  |  | 0 |  |  |  | 0 |  |  |  | 465 |  |  |  | 0 |  |  |  | (8 | ) |  |  | 473 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | $ | 35,576 |  |  | $ | 1,089 |  |  | $ | (285 | ) |  | $ | 36,380 |  |  | $ | 6,076 |  |  | $ | 25,371 |  |  | $ | 4,933 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**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**  **Unrealized**  **Losses** | |  |
|  |  |  |  | | | | |  |  |  |  | | | | |  |  |  |  |  |  |
| **(In millions)** |  | **Fair Value** | |  |  | **Unrealized Losses** | |  |  | **Fair Value** | |  |  | **Unrealized Losses** | |  |  | **Total Fair Value** | |  |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2018** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| 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** | **)** |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | | | | | |  | | | | | | | |  | | | |  | | | |
|  |  | **Less than 12 Months** | | | | | |  |  | **12 Months or Greater** | | | | | |  |  |  | |  |  | **Total Unrealized Losses** | |  |
|  |  |  |  | | | | |  |  |  |  | | | | |  |  |  |  |  |  |
| **(In millions)** |  | **Fair Value** | |  |  | **Unrealized Losses** | |  |  | **Fair Value** | |  |  | **Unrealized Losses** | |  |  | **Total Fair Value** | |  |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2017** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Mutual funds |  | $ | 3 |  |  | $ | (1 | ) |  | $ | 77 |  |  | $ | (24 | ) |  | $ | 80 |  |  | $ | (25 | ) |
| U.S. Government and Agency securities |  |  | 4,033 |  |  |  | (5 | ) |  |  | 0 |  |  |  | 0 |  |  |  | 4,033 |  |  |  | (5 | ) |
| Foreign government bonds |  |  | 1,444 |  |  |  | (3 | ) |  |  | 669 |  |  |  | (1 | ) |  |  | 2,113 |  |  |  | (4 | ) |
| Mortgage-backed securities |  |  | 503 |  |  |  | (16 | ) |  |  | 0 |  |  |  | 0 |  |  |  | 503 |  |  |  | (16 | ) |
| Corporate notes and bonds |  |  | 713 |  |  |  | (10 | ) |  |  | 504 |  |  |  | (42 | ) |  |  | 1,217 |  |  |  | (52 | ) |
| Municipal securities |  |  | 16 |  |  |  | (1 | ) |  |  | 0 |  |  |  | 0 |  |  |  | 16 |  |  |  | (1 | ) |
| Common and preferred stock |  |  | 1,154 |  |  |  | (135 | ) |  |  | 120 |  |  |  | (47 | ) |  |  | 1,274 |  |  |  | (182 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | $ | 7,866 |  |  | $ | (171 | ) |  | $ | 1,370 |  |  | $ | (114 | ) |  | $ | 9,236 |  |  | $ | (285 | ) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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 June 30, 2018.

At June 30, 2018 and 2017, 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 $216 million and $204 million, respectively.

**Debt Investment Maturities**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Cost Basis** | |  |  | **Estimated**  **Fair Value** | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30, 2018** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Due in one year or less |  | $ | 12,489 |  |  | $ | 12,526 |  |
| Due after one year through five years |  |  | 14,987 |  |  |  | 15,283 |  |
| Due after five years through 10 years |  |  | 2,137 |  |  |  | 2,242 |  |
| Due after 10 years |  |  | 3,791 |  |  |  | 3,952 |  |
|  | | | |  |  |  |  |  |
| Total |  | $ | 33,404 |  |  | $ | 34,003 |  |
|  |  |  |  |  |  |  |  |  |

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 June 30, 2018 and 2017, the total notional amounts of these foreign exchange contracts sold were $9.3 billion and $7.2 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 June 30, 2018 and 2017, the total notional amounts of these foreign exchange contracts sold were $523 million and $3.5 billion, respectively. Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of June 30, 2018, the total notional amounts of these foreign exchange contracts purchased and sold were $7.8 billion and $5.3 billion, respectively. As of June 30, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were $3.2 billion and $3.6 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 June 30, 2018, the total notional amounts of designated and non-designated equity contracts purchased and sold were $918 million and $472 million, respectively. As of June 30, 2017, the total notional amounts of designated and non-designated equity contracts purchased and sold were immaterial.

**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 June 30, 2018, the total notional amounts of fixed-interest rate contracts purchased and sold were $3.1 billion and $1.8 billion, respectively. As of June 30, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were $2.7 billion and $456 million, 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 June 30, 2018 and 2017, the total notional derivative amount of mortgage contracts purchased were immaterial and $1.3 billion, 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 June 30, 2018 and 2017, the total notional amounts of credit contracts purchased and sold were immaterial.

**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 June 30, 2018, the total notional amounts of commodity contracts purchased and sold were $1.1 billion and $376 million, respectively. As of June 30, 2017, the total notional amounts of commodity contracts purchased and sold were $543 million and $33 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 June 30, 2018, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral is required to be posted.

**Fair Values of Derivative Instruments**

Following are the gross fair values of derivative instruments held at June 30, 2018 and 2017, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Foreign**  **Exchange**  **Contracts** | |  |  | **Equity**  **Contracts** | |  |  | **Interest**  **Rate**  **Contracts** | |  |  | **Credit**  **Contracts** | |  |  | **Commodity**  **Contracts** | |  |  | **Total**  **Derivatives** | |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2018** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Assets** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Derivatives not designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| 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** |  |
| Derivatives designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| 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** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Derivatives not designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Other current liabilities |  | **$** | **(60** | **)** |  | **$** | **(17** | **)** |  | **$** | **(33** | **)** |  | **$** | **(41** | **)** |  | **$** | **(5** | **)** |  | **$** | **(156** | **)** |
| Derivatives designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Other current liabilities |  | **$** | **(9** | **)** |  | **$** | **0** |  |  | **$** | **0** |  |  | **$** | **0** |  |  | **$** | **0** |  |  | **$** | **(9** | **)** |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total liabilities |  | **$** | **(69** | **)** |  | **$** | **(17** | **)** |  | **$** | **(33** | **)** |  | **$** | **(41** | **)** |  | **$** | **(5** | **)** |  | **$** | **(165** | **)** |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Foreign**  **Exchange**  **Contracts** | |  |  | **Equity**  **Contracts** | |  |  | **Interest**  **Rate**  **Contracts** | |  |  | **Credit**  **Contracts** | |  |  | **Commodity**  **Contracts** | |  |  | **Total**  **Derivatives** | |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2017** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Assets** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Derivatives not designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Short-term investments |  | $ | 9 |  |  | $ | 78 |  |  | $ | 44 |  |  | $ | 21 |  |  | $ | 2 |  |  | $ | 154 |  |
| Other current assets |  |  | 48 |  |  |  | 0 |  |  |  | 0 |  |  |  | 0 |  |  |  | 0 |  |  |  | 48 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | $ | 57 |  |  | $ | 78 |  |  | $ | 44 |  |  | $ | 21 |  |  | $ | 2 |  |  | $ | 202 |  |
| Derivatives designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Short-term investments |  | $ | 12 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 12 |  |
| Other current assets |  |  | 417 |  |  |  | 0 |  |  |  | 0 |  |  |  | 0 |  |  |  | 0 |  |  |  | 417 |  |
| Equity and other investments |  |  | 0 |  |  |  | 2 |  |  |  | 0 |  |  |  | 0 |  |  |  | 0 |  |  |  | 2 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | $ | 429 |  |  | $ | 2 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 431 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total assets |  | $ | 486 |  |  | $ | 80 |  |  | $ | 44 |  |  | $ | 21 |  |  | $ | 2 |  |  | $ | 633 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Liabilities** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Derivatives not designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Other current liabilities |  | $ | (183 | ) |  | $ | (3 | ) |  | $ | (20 | ) |  | $ | (62 | ) |  | $ | (6 | ) |  | $ | (274 | ) |
| Derivatives designated as hedging instruments: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Other current liabilities |  | $ | (75 | ) |  | $ | 0 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | (75 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total liabilities |  | $ | (258 | ) |  | $ | (3 | ) |  | $ | (20 | ) |  | $ | (62 | ) |  | $ | (6 | ) |  | $ | (349 | ) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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

**Fair-Value Hedges**

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

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| **Foreign Exchange Contracts** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Derivatives |  | **$** | **(57** | **)** |  | $ | 121 |  |
| Hedged items |  |  | **60** |  |  |  | (120 | ) |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **3** |  |  | $ | 1 |  |
|  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |
| **Equity Contracts** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Derivatives |  | **$** | **0** |  |  | $ | 191 |  |
| Hedged items |  |  | **0** |  |  |  | (211 | ) |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **0** |  |  | $ | (20 | ) |
|  |  |  |  |  |  |  |  |  |

**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 period):

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| **Effective Portion** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Gain recognized in OCI, net of tax effect of **$188** and $472 |  | **$** | **349** |  |  | $ | 876 |  |
| Gain reclassified from OCI into revenue |  | **$** | **495** |  |  | $ | 884 |  |
|  |  | | | |  | | | |
| **Amount Excluded from Effectiveness Assessment and Ineffective Portion** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Loss recognized in other income (expense) |  | **$** | **(174** | **)** |  | $ | (314 | ) |

We estimate that $496 million of net derivative gains 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 fiscal year 2018.

**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 fiscal years 2018 and 2017. 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)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Foreign exchange contracts |  | **$** | **106** |  |  | $ | (234 | ) |
| Equity contracts |  |  | **12** |  |  |  | (131 | ) |
| Interest-rate contracts |  |  | **(4** | **)** |  |  | 5 |  |
| Credit contracts |  |  | **22** |  |  |  | (18 | ) |
| Commodity contracts |  |  | **(1** | **)** |  |  | (126 | ) |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **135** |  |  | $ | (504 | ) |
|  |  |  |  |  |  |  |  |  |

NOTE 6 — FAIR VALUE MEASUREMENTS

**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** |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2018** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **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** |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **(In millions)** |  |  | **Level 1** |  |  |  | **Level 2** |  |  |  | **Level 3** |  |  |  | **Gross**  **Fair**  **Value** |  |  |  | **Netting** | **(a)** |  |  | **Net Fair Value** |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **June 30, 2017** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Assets** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Mutual funds |  | $ | 982 |  |  | $ | 0 |  |  | $ | 0 |  |  | $ | 982 |  |  | $ | 0 |  |  | $ | 982 |  |
| Commercial paper |  |  | 0 |  |  |  | 2,601 |  |  |  | 0 |  |  |  | 2,601 |  |  |  | 0 |  |  |  | 2,601 |  |
| Certificates of deposit |  |  | 0 |  |  |  | 555 |  |  |  | 0 |  |  |  | 555 |  |  |  | 0 |  |  |  | 555 |  |
| U.S. Government and Agency securities |  |  | 7,134 |  |  |  | 6,105 |  |  |  | 0 |  |  |  | 13,239 |  |  |  | 0 |  |  |  | 13,239 |  |
| Foreign government bonds |  |  | 501 |  |  |  | 3,022 |  |  |  | 0 |  |  |  | 3,523 |  |  |  | 0 |  |  |  | 3,523 |  |
| Mortgage-backed securities |  |  | 0 |  |  |  | 3,593 |  |  |  | 0 |  |  |  | 3,593 |  |  |  | 0 |  |  |  | 3,593 |  |
| Corporate notes and bonds |  |  | 0 |  |  |  | 4,073 |  |  |  | 253 |  |  |  | 4,326 |  |  |  | 0 |  |  |  | 4,326 |  |
| Municipal securities |  |  | 0 |  |  |  | 256 |  |  |  | 0 |  |  |  | 256 |  |  |  | 0 |  |  |  | 256 |  |
| Common and preferred stock |  |  | 4,218 |  |  |  | 28 |  |  |  | 5 |  |  |  | 4,251 |  |  |  | 0 |  |  |  | 4,251 |  |
| Derivatives |  |  | 5 |  |  |  | 623 |  |  |  | 5 |  |  |  | 633 |  |  |  | (235 | ) |  |  | 398 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | $ | 12,840 |  |  | $ | 20,856 |  |  | $ | 263 |  |  | $ | 33,959 |  |  | $ | (235 | ) |  | $ | 33,724 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Liabilities** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Derivatives and other |  | $ | 5 |  |  | $ | 344 |  |  | $ | 0 |  |  | $ | 349 |  |  | $ | (231 | ) |  | $ | 118 |  |

(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.*

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 June 30, 2018 and 2017.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Net fair value of assets measured at fair value on a recurring basis |  | **$** | **42,645** |  |  | $ | 33,724 |  |
| Cash |  |  | **1,661** |  |  |  | 2,064 |  |
| Common and preferred stock measured at fair value on a nonrecurring basis |  |  | **216** |  |  |  | 204 |  |
| Other investments measured at fair value on a nonrecurring basis |  |  | **502** |  |  |  | 465 |  |
| Derivative assets classified as other current assets |  |  | **(597** | **)** |  |  | (465 | ) |
| Derivative liabilities under master netting agreements classified as other current assets |  |  | **53** |  |  |  | 231 |  |
| Other |  |  | **62** |  |  |  | 157 |  |
|  | | | |  |  |  |  |  |
| Recorded basis of investment components |  | **$** | **44,542** |  |  | $ | 36,380 |  |
|  |  |  |  |  |  |  |  |  |

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

The following tables present the changes during the fiscal years 2018 and 2017 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** | |  |
|  | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |
| **Year Ended June 30, 2018** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |
| Balance, beginning of period |  | **$** | **253** |  |  | **$** | **5** |  |  | **$** | **5** |  |  | **$** | **263** |  |
| Total realized and unrealized gains (losses): |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Included in other income (expense) |  |  | **6** |  |  |  | **0** |  |  |  | **4** |  |  |  | **10** |  |
| Included in other comprehensive income |  |  | **(92** | **)** |  |  | **0** |  |  |  | **0** |  |  |  | **(92** | **)** |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance, end of period |  | **$** | **167** |  |  | **$** | **5** |  |  | **$** | **9** |  |  | **$** | **181** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Change in unrealized gains (losses) included in other income (expense) related to assets held as of June 30, 2018 |  | **$** | **6** |  |  | **$** | **0** |  |  | **$** | **4** |  |  | **$** | **10** |  |
|  | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |
| **(In millions)** |  | **Corporate Notes and Bonds** | |  |  | **Common and Preferred Stock** | |  |  | **Derivative Assets** | |  |  | **Total** | |  |
|  | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |
| **Year Ended June 30, 2017** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |
| Balance, beginning of period |  | $ | 138 |  |  | $ | 8 |  |  | $ | 71 |  |  | $ | 217 |  |
| Total realized and unrealized gains (losses): |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Included in other income (expense) |  |  | (6 | ) |  |  | (6 | ) |  |  | 51 |  |  |  | 39 |  |
| Included in other comprehensive income |  |  | 111 |  |  |  | 0 |  |  |  | 0 |  |  |  | 111 |  |
| Purchases, issuances, and settlements |  |  | 0 |  |  |  | 5 |  |  |  | (119 | ) |  |  | (114 | ) |
| Transfers in (out) |  |  | 10 |  |  |  | (2 | ) |  |  | 2 |  |  |  | 10 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance, end of period |  | $ | 253 |  |  | $ | 5 |  |  | $ | 5 |  |  | $ | 263 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Change in unrealized gains (losses) included in other income (expense) related to assets held as of June 30, 2017 |  | $ | (7 | ) |  | $ | (5 | ) |  | $ | 4 |  |  | $ | (8 | ) |

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

During fiscal years 2018 and 2017, impairment charges of $5 million and $86 million, respectively, were recognized for certain investments measured at fair value on a nonrecurring basis, as the decline in their respective fair values below their cost was determined to be other than temporary in all instances. At June 30, 2018 and 2017, the fair values of the common and preferred stocks that we held that were required to be measured at fair value on a non-recurring basis were $0 and $164 million, respectively.

NOTE 7 — INVENTORIES

The components of inventories were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** | | | | | | | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Raw materials |  | **$** | **172** |  |  | $ | 170 |  |
| Work in process |  |  | **16** |  |  |  | 45 |  |
| Finished goods |  |  | **552** |  |  |  | 502 |  |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **740** |  |  | $ | 717 |  |
|  |  |  |  |  |  |  |  |  |

NOTE 8 — PROPERTY AND EQUIPMENT

The components of property and equipment were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** | | | | | | | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Land |  | **$** | **526** |  |  | $ | 526 |  |
| Buildings and improvements |  |  | **6,087** |  |  |  | 5,886 |  |
| Leasehold improvements |  |  | **2,100** |  |  |  | 1,938 |  |
| Computer equipment and software |  |  | **5,673** |  |  |  | 4,989 |  |
| Furniture and equipment |  |  | **1,873** |  |  |  | 1,743 |  |
|  | | | |  |  |  |  |  |
| Total, at cost |  |  | **16,259** |  |  |  | 15,082 |  |
| Accumulated depreciation |  |  | **(8,629** | **)** |  |  | (7,547 | ) |
|  | | | |  |  |  |  |  |
| Total, net |  | **$** | **7,630** |  |  | $ | 7,535 |  |
|  |  |  |  |  |  |  |  |  |

During fiscal years 2018, 2017, and 2016, depreciation expense was $1.8 billion, $1.7 billion, and $1.4 billion, respectively.

NOTE 9 — BUSINESS COMBINATIONS

During fiscal year 2018, we acquired five entities for total consideration of $267 million, substantially all of which was paid in cash. During this period, we also sold three entities for total consideration of $600 million, including Razorfish in the second quarter of fiscal year 2018. These entities have been included in or removed from our consolidated results of operations since their acquisition or sale dates, respectively. Pro forma results of operations have not been presented because the effects of these business combinations, individually and in the aggregate, were not material to our consolidated results of operations.

NOTE 10 — GOODWILL

Changes in the carrying amount of goodwill for fiscal years 2018 and 2017 by segment were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Balance as**  **of June 30,**  **2016** | |  |  | **Acquisitions** | |  |  | **Purchase**  **Accounting**  **Adjustments**  **and Other** | |  |  | **Balance as**  **of June 30,**  **2017** | |  |  | **Acquisitions** | |  |  | **Purchase**  **Accounting**  **Adjustments**  **and Other** | |  |  | **Balance as**  **of June 30,**  **2018** | |  |
|  | | | | | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Windows & Windows Live Division |  | $ | 153 |  |  | $ | 1 |  |  | $ | (77 | ) |  | $ | 77 |  |  | **$** | **0** |  |  | **$** | **0** |  |  | **$** | **77** |  |
| Server and Tools |  |  | 738 |  |  |  | 233 |  |  |  | 67 |  |  |  | 1,038 |  |  |  | **82** |  |  |  | **(2** | **)** |  |  | **1,118** |  |
| Online Services Division |  |  | 6,274 |  |  |  | 447 |  |  |  | (64 | ) |  |  | 6,657 |  |  |  | **0** |  |  |  | **(284** | **)** |  |  | **6,373** |  |
| Espresso Business Division |  |  | 4,191 |  |  |  | 0 |  |  |  | (264 | ) |  |  | 3,927 |  |  |  | **116** |  |  |  | **(19** | **)** |  |  | **4,024** |  |
| Entertainment and Devices Division |  |  | 752 |  |  |  | 58 |  |  |  | (6 | ) |  |  | 804 |  |  |  | **0** |  |  |  | **(2** | **)** |  |  | **802** |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | $ | 12,108 |  |  | $ | 739 |  |  | $ | (344 | ) |  | $ | 12,503 |  |  | **$** | **198** |  |  | **$** | **(307** | **)** |  | **$** | **12,394** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

None of the amounts recorded as goodwill are expected 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” for fiscal year 2018 is $285 million of goodwill associated with business dispositions. See also Note 9 – Business Combinations.

We test goodwill for impairment annually on May 1 at the reporting unit level using a fair value approach. No impairment of goodwill was identified as of May 1, 2018. In connection with the disposal of Razorfish, we performed an interim impairment analysis of our Online Services Division goodwill balance during the first quarter of fiscal year 2018. No impairment of goodwill was identified.

NOTE 11 — INTANGIBLE ASSETS

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Gross Carrying Amount** | |  |  | **Accumulated Amortization** | |  |  | **Net Carrying Amount** | |  |  | **Gross Carrying Amount** | |  |  | **Accumulated Amortization** | |  |  | **Net Carrying Amount** | |  |
|  | | | | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  |  | |  |  |  | |  |  | **2018** | |  |  |  | |  |  |  | |  |  | **2017** | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |  | | | |
| Contract-based |  | **$** | **1,075** |  |  | **$** | **(914** | **)** |  | **$** | **161** |  |  | $ | 1,087 |  |  | $ | (855 | ) |  | $ | 232 |  |
| Technology-based |  |  | **2,308** |  |  |  | **(1,521** | **)** |  |  | **787** |  |  |  | 2,033 |  |  |  | (1,090 | ) |  |  | 943 |  |
| Marketing-related |  |  | **114** |  |  |  | **(86** | **)** |  |  | **28** |  |  |  | 188 |  |  |  | (97 | ) |  |  | 91 |  |
| Customer-related |  |  | **390** |  |  |  | **(208** | **)** |  |  | **182** |  |  |  | 732 |  |  |  | (239 | ) |  |  | 493 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **3,887** |  |  | **$** | **(2,729** | **)** |  | **$** | **1,158** |  |  | $ | 4,040 |  |  | $ | (2,281 | ) |  | $ | 1,759 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

We estimate that we have no significant residual value related to our intangible assets. No material impairments of intangible assets were identified during any of the periods presented.

The components of intangible assets acquired during fiscal years 2018 and 2017 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Amount** | |  |  | **Weighted**  **Average Life** |  | **Amount** | |  |  | **Weighted**  **Average Life** |
|  | | | | | | | | | | | | |
|  |  | | | |  | |  | | | |  | |
| **Year Ended June 30,** |  | **2018** | |  |  |  |  | **2017** | |  |  |  |
|  |  | | | |  | |  | | | |  | |
| Contract-based |  | **$** | **3** |  |  | **2 years** |  | $ | 26 |  |  | 4 years |
| Technology-based |  |  | **322** |  |  | **4 years** |  |  | 293 |  |  | 4 years |
| Marketing-related |  |  | **0** |  |  |  |  |  | 7 |  |  | 5 years |
| Customer-related |  |  | **18** |  |  | **5 years** |  |  | 28 |  |  | 2 years |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **343** |  |  |  |  | $ | 354 |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

Intangible assets amortization expense was $707 million, $591 million, and $472 million for fiscal years 2018, 2017, and 2016, respectively. The following table outlines the estimated future amortization expense related to intangible assets held at June 30, 2018:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |
|  | | | |  |
|  |  | | | |
| **Year Ending June 30,** |  |  | |  |
|  |  | | | |
| 2011 |  | $ | 486 |  |
| 2012 |  |  | 365 |  |
| 2013 |  |  | 235 |  |
| 2014 |  |  | 36 |  |
| 2015 and thereafter |  |  | 36 |  |
|  | | | |  |
| Total |  | $ | 1,158 |  |
|  |  |  |  |  |

NOTE 12 — DEBT

In September 2016, our Board of Directors authorized debt financings of up to $6.0 billion. As of June 30, 2018, we had $6.0 billion of issued and outstanding debt comprised of $1.0 billion of commercial paper and $5.0 billion of long-term debt, including $1.25 billion of convertible debt. Cash paid for interest on our debt for fiscal year 2018 was $145 million. No cash was paid for interest on our debt for fiscal years 2017 and 2016.

**Short-term Debt**

As of June 30, 2018, our $1.0 billion of commercial paper issued and outstanding had a weighted average interest rate, including issuance costs, of 0.20% and maturities of 22 to 216 days. The estimated fair value of this commercial paper approximates its carrying value.

In November 2017, we replaced our $2.0 billion and $1.0 billion credit facilities with a $2.25 billion 364-day credit facility, which expires on November 5, 2018. This facility serves as a back-up for our commercial paper program. In June 2018, we reduced the size of our credit facility from $2.25 billion to $1.0 billion due to the reduction in commercial paper outstanding. As of June 30, 2018, we were in compliance with the financial covenant in the credit facility agreement, which requires a coverage ratio be maintained of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense. No amounts were drawn against the credit facility during any of the periods presented.

**Long-term Debt**

*Notes*

As of June 30, 2018, we had issued and outstanding $3.75 billion of debt securities as illustrated in the table below (collectively “the Notes”). Interest on the Notes is payable semi-annually on June 1 and December 1 of each year, to holders of record on the preceding May 15 and November 15. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

*Convertible Debt*

In June 2018, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses which were capitalized. The majority of the proceeds were used to repay outstanding commercial paper, leaving $1.0 billion of commercial paper outstanding as of June 30, 2018. Each $1,000 principal amount of notes is convertible into 29.94 shares of Espresso 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 Espresso’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.

As of June 30, 2018, the total carrying value and estimated fair value of our long-term debt, including convertible debt, were $4.94 billion and $5.21 billion, respectively. The estimate of fair value is based on quoted prices for our publicly-traded debt as of June 30, 2018, as applicable. The effective interest yields of the Notes due in 2014, 2019, and 2039 were 3.00%, 4.29%, and 5.22%, respectively, at June 30, 2018. The effective interest yield of the convertible debt due in 2013 is 1.85% at June 30, 2018 and the coupon interest rate is zero percent.

The components of long-term debt as of June 30, 2018 were as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |
|  | | | |  |
|  |  | | | |
| Zero coupon convertible notes due on June 15, 2013 |  | **$** | **1,250** |  |
| 2.95% Notes due on June 1, 2014 |  |  | **2,000** |  |
| 4.20% Notes due on June 1, 2019 |  |  | **1,000** |  |
| 5.20% Notes due on June 1, 2039 |  |  | **750** |  |
| Unamortized discount for Notes above |  |  | **(61** | **)** |
|  | | | |  |
| Total |  | **$** | **4,939** |  |
|  |  |  |  |  |

Maturities of long-term debt for the next five years are as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |
|  | | | |  |
|  |  | | | |
| **Year Ending June 30,** |  |  | |  |
|  |  | | | |
| 2011 |  | $ | 0 |  |
| 2012 |  |  | 0 |  |
| 2013 |  |  | 1,250 |  |
| 2014 |  |  | 2,000 |  |
| 2015 |  |  | 0 |  |
| Thereafter |  |  | 1,750 |  |
|  | | | |  |
| Total |  | $ | 5,000 |  |
|  |  |  |  |  |

NOTE 13 — INCOME TAXES

The components of the provision for income taxes were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** | | | | | | | | | | | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| **Current Taxes** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| U.S. federal |  | **$** | **4,415** |  |  | $ | 3,159 |  |  | $ | 4,357 |  |
| U.S. state and local |  |  | **357** |  |  |  | 192 |  |  |  | 256 |  |
| International |  |  | **1,701** |  |  |  | 1,139 |  |  |  | 1,007 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Current taxes |  |  | **6,473** |  |  |  | 4,490 |  |  |  | 5,620 |  |
|  |  | | | |  | | | |  | | | |
| **Deferred Taxes** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| Deferred taxes |  |  | **(220** | **)** |  |  | 762 |  |  |  | 513 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Provision for income taxes |  | **$** | **6,253** |  |  | $ | 5,252 |  |  | $ | 6,133 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

U.S. and international components of income before income taxes were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** | | | | | | | | | | | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| U.S. |  | **$** | **9,575** |  |  | $ | 5,529 |  |  | $ | 12,682 |  |
| International |  |  | **15,438** |  |  |  | 14,292 |  |  |  | 11,132 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Income before income taxes |  | **$** | **25,013** |  |  | $ | 19,821 |  |  | $ | 23,814 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

The items accounting for the difference between income taxes computed at the federal statutory rate and the provision for income taxes were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | | |  | | |  | |
| **Year Ended June 30,** |  | **2018** |  |  | **2017** |  |  | **2016** |
|  |  | | |  | | |  | |
| Federal statutory rate |  | **35.0%** |  |  | 35.0% |  |  | 35.0% |
| Effect of: |  |  |  |  |  |  |  |  |
| Foreign earnings taxed at lower rates |  | **(12.1)%** |  |  | (9.3)% |  |  | (7.0)% |
| Internal Revenue Service settlement |  | **0%** |  |  | 0% |  |  | (5.8)% |
| European Commission fine |  | **0%** |  |  | 0% |  |  | 2.1% |
| Other reconciling items, net |  | **2.1%** |  |  | 0.8% |  |  | 1.5% |
|  | | |  |  |  |  |  |  |
| Effective rate |  | **25.0%** |  |  | 26.5% |  |  | 25.8% |
|  |  |  |  |  |  |  |  |  |

In general, other reconciling items consist of interest, U.S. state income taxes, domestic production deductions, and research credits. In fiscal years 2018, 2017 and 2016, there were no individually significant other reconciling items.

The components of the deferred income tax assets and liabilities were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| **Deferred Income Tax Assets** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Stock-based compensation expense |  | **$** | **1,329** |  |  | $ | 2,004 |  |
| Other expense items |  |  | **1,696** |  |  |  | 1,595 |  |
| Unearned revenue |  |  | **556** |  |  |  | 743 |  |
| Impaired investments |  |  | **289** |  |  |  | 236 |  |
| Other revenue items |  |  | **80** |  |  |  | 120 |  |
|  | | | |  |  |  |  |  |
| Deferred income tax assets |  | **$** | **3,950** |  |  | $ | 4,698 |  |
|  | | | |  |  |  |  |  |
|  |  | | | |  | | | |
| **Deferred Income Tax Liabilities** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| International earnings |  | **$** | **(1,056** | **)** |  | $ | (1,191 | ) |
| Unrealized gain on investments |  |  | **(674** | **)** |  |  | (516 | ) |
| Other |  |  | **(265** | **)** |  |  | (499 | ) |
|  | | | |  |  |  |  |  |
| Deferred income tax liabilities |  |  | **(1,995** | **)** |  |  | (2,206 | ) |
|  | | | |  |  |  |  |  |
| Net deferred income tax assets |  | **$** | **1,955** |  |  | $ | 2,492 |  |
|  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |
| **Reported As** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Current deferred income tax assets |  | **$** | **2,184** |  |  | $ | 2,213 |  |
| Long-term deferred income tax assets (liabilities) |  |  | **(229** | **)** |  |  | 279 |  |
|  | | | |  |  |  |  |  |
| Net deferred income tax assets |  | **$** | **1,955** |  |  | $ | 2,492 |  |
|  |  |  |  |  |  |  |  |  |

Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases and are stated at enacted tax rates expected to be in effect when the taxes are actually paid or recovered.

We have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $29.5 billion resulting from earnings for certain non-U.S. subsidiaries which are permanently reinvested outside the U.S. The unrecognized deferred tax liability associated with these temporary differences is approximately $9.2 billion.

Income taxes paid were $4.1 billion, $6.6 billion, and $5.4 billion in fiscal years 2018, 2017, and 2016, respectively.

**Uncertain Tax Positions**

As of June 30, 2018, we had $6.5 billion of unrecognized tax benefits of which $5.6 billion, if recognized, would affect our effective tax rate. As of June 30, 2017, we had $5.4 billion of unrecognized tax benefits of which $4.4 billion, if recognized, would affect our effective tax rate.

Interest on unrecognized tax benefits was $193 million, $230 million, and $121 million in fiscal years 2018, 2017 and 2016, respectively. As of June 30, 2018, 2017 and 2016, we had accrued interest related to uncertain tax positions of $747 million, $554 million, and $324 million, respectively, net of federal income tax benefits.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** | | | | | | | | | | | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Balance, beginning of year |  | **$** | **5,403** |  |  | $ | 3,195 |  |  | $ | 7,076 |  |
| Decreases related to settlements |  |  | **(57** | **)** |  |  | (82 | ) |  |  | (4,787 | ) |
| Increases for tax positions related to the current year |  |  | **1,012** |  |  |  | 2,203 |  |  |  | 934 |  |
| Increases for tax positions related to prior years |  |  | **364** |  |  |  | 239 |  |  |  | 66 |  |
| Decreases for tax positions related to prior years |  |  | **(166** | **)** |  |  | (132 | ) |  |  | (80 | ) |
| Reductions due to lapsed statute of limitations |  |  | **(14** | **)** |  |  | (20 | ) |  |  | (14 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Balance, end of year |  | **$** | **6,542** |  |  | $ | 5,403 |  |  | $ | 3,195 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

We are under audit by the IRS for the tax years 2004-2006. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months as we do not believe the examination will be concluded within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S., and certain jurisdictions are under audit by local tax authorities. The resolutions of these audits are not expected to be material to our financial statements.

NOTE 14 — UNEARNED REVENUE

Unearned revenue comprises mainly unearned revenue from volume licensing programs, as well as payments for undelivered elements and for other offerings for which we earn the revenue when we provide the service or software or otherwise meet the revenue recognition criteria.

**Volume Licensing Programs**

Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid 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.

**Undelivered Elements**

Undelivered elements consist mainly of payments for unspecified upgrades or enhancements of Espresso Internet Explorer on a when-and-if-available basis for Windows XP, and technology guarantee programs.

**Other**

Also included in unearned revenue are payments for post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions; Espresso Dynamics business solutions products; 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 components of unearned revenue were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Volume licensing programs |  | **$** | **12,180** |  |  | $ | 11,350 |  |
| Undelivered elements |  |  | **624** |  |  |  | 1,083 |  |
| Other |  |  | **2,026** |  |  |  | 1,851 |  |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **14,830** |  |  | $ | 14,284 |  |
|  |  |  |  |  |  |  |  |  |

Unearned revenue by segment was as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Windows & Windows Live Division |  | **$** | **1,701** |  |  | $ | 2,345 |  |
| Server and Tools |  |  | **5,282** |  |  |  | 4,732 |  |
| Espresso Business Division |  |  | **7,004** |  |  |  | 6,508 |  |
| Other segments |  |  | **843** |  |  |  | 699 |  |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **14,830** |  |  | $ | 14,284 |  |
|  |  |  |  |  |  |  |  |  |

NOTE 15 — OTHER LONG-TERM LIABILITIES

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Tax contingencies and other tax liabilities |  | **$** | **6,887** |  |  | $ | 5,515 |  |
| Legal contingencies |  |  | **236** |  |  |  | 407 |  |
| Product warranty |  |  | **69** |  |  |  | 132 |  |
| Other |  |  | **253** |  |  |  | 215 |  |
|  | | | |  |  |  |  |  |
| Total |  | **$** | **7,445** |  |  | $ | 6,269 |  |
|  |  |  |  |  |  |  |  |  |

NOTE 16 — COMMITMENTS AND GUARANTEES

**Construction and Operating Leases**

We have committed $347 million for constructing new buildings, building improvements and leasehold improvements as of June 30, 2018.

We have operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for facilities operating leases was $530 million, $475 million, and $398 million, in fiscal years 2018, 2017, and 2016, respectively. Future minimum rental commitments under noncancellable facilities operating leases in place as of June 30, 2018 are as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |
|  | | | |  |
|  |  | | | |
| **Year Ending June 30,** |  |  | |  |
|  |  | | | |
| 2011 |  | $ | 437 |  |
| 2012 |  |  | 322 |  |
| 2013 |  |  | 256 |  |
| 2014 |  |  | 206 |  |
| 2015 and thereafter |  |  | 677 |  |
|  | | | |  |
| Total |  | $ | 1,898 |  |
|  |  |  |  |  |

**Indemnifications**

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. We evaluate estimated losses for these indemnifications, and we consider such factors as the degree of probability of an unfavorable outcome and the 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.

**Yahoo! Commercial Agreement**

On December 4, 2017, we entered into a definitive agreement with Yahoo! whereby Espresso will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. The transaction received clearance, without restrictions, from both the U.S. Department of Justice and the European Commission during the third fiscal quarter of 2018. The term of the agreement is 10 years subject to termination provisions after five years based on performance.

Espresso provided Yahoo! country level revenue per search guarantees for a period of 18 months after implementation of the Bing search platform. These guarantees are calculated, paid, and trued-up in three six-month periods thereafter, and are intended to insure Yahoo! against any persistent drop in revenue per search from pre-implementation levels. This is a rate guarantee not a guarantee of search volume. We estimate the total cost of the revenue per search guarantees during the guarantee period could range between zero and $150 million; however, no amount has been recorded for the revenue per search guarantees as we do not believe that such liability exists at this time.

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

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

**Product Warranty**

The changes in our aggregate product warranty liabilities, which are included in other current liabilities and other long term-liabilities on our balance sheets, were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Balance, beginning of year |  | **$** | **342** |  |  | $ | 692 |  |
| Accruals for warranties issued |  |  | **144** |  |  |  | 161 |  |
| Adjustments to pre-existing warranties |  |  | **(2** | **)** |  |  | 0 |  |
| Settlements of warranty claims |  |  | **(244** | **)** |  |  | (511 | ) |
|  | | | |  |  |  |  |  |
| Balance, end of year |  | **$** | **240** |  |  | $ | 342 |  |
|  |  |  |  |  |  |  |  |  |

NOTE 17 — CONTINGENCIES

**Government Competition Law Matters**

In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were “not reasonable.” Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should accrue after that date. On February 27, 2016, the Commission issued a fine of $1.4 billion (€899 million) relating to the period prior to October 22, 2007. In May 2016, we filed an application with the European Court of First Instance to annul the February 2016 fine. We paid the $1.4 billion (€899 million) fine in June 2016, pending the outcome of the appeal.

In January 2016, the Commission opened a competition law investigation that relates primarily to interoperability with respect to our Espresso Office family of products. This investigation resulted from complaints filed with the Commission by a trade association of Espresso’s competitors. Espresso has made a number of proposals to address the Commission’s competition law concerns in this area. The Commission announced on December 16, 2017 that it welcomed these proposals and that it will take them into account in assessing this matter. During the fourth quarter of fiscal year 2018, the trade association withdrew its complaint that was the basis of the investigation.

We are also 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 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 June 30, 2018, we have recorded a liability related to these claims of approximately $651 million, which reflects our estimated exposure of $1.9 billion less payments made to date of approximately $1.2 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 2018, 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. On March 30, 2018, the trial court granted summary judgment in favor of Espresso 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 2016, 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 2016, 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 2016, we entered into a settlement agreement resolving all other litigation pending between Espresso and Alcatel-Lucent, leaving approximately $500 million remaining in dispute. In September 2017, 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 has been set for the first week of December 2018.

In October 2003, Uniloc USA Inc., a subsidiary of a Singapore-based security technology company, filed a patent infringement suit in U.S. District Court in Rhode Island, claiming that product activation technology in Windows XP and certain other Espresso 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 2017, the jury returned a $388 million verdict against us, including a finding of willful infringement. In September 2017, the district court judge overturned the jury verdict, ruling that the evidence did not support the jury’s finding that Espresso infringed the patent. Uniloc has appealed.

In March 2007, i4i Limited Partnership sued Espresso in U.S. District Court in Texas claiming that certain custom XML technology in Word 2003 and 2007 infringed i4i’s patent. In May 2017, a jury returned a verdict against us, finding damages of $200 million and that we willfully infringed the patent. In August 2017, 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. On December 22, 2017, 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, 2018. On April 1, 2018, the court of appeals denied our request for a rehearing. We intend to seek review by the U.S. Supreme Court.

In 2007, VirnetX Inc. brought suit in U.S. District Court in Texas claiming that various Espresso products including Windows client and server operating systems software and communications software infringe two patents related to technology for securely communicating over the Internet. This case was tried by a jury in March 2018. The jury returned a verdict that Espresso willfully infringed both patents, and found damages of approximately $106 million. In March 2018, VirnetX filed a new lawsuit in the Eastern District of Texas alleging that additional Espresso products and services including Windows 7 and Windows Server 2016 R2 infringe the same two patents. The parties have reached an agreement to settle both lawsuits.

There are over 50 other patent infringement cases pending against Espresso, 10 of which are set for trial in fiscal year 2018.

**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 June 30, 2018, we had accrued aggregate liabilities of approximately $1.0 billion in other current liabilities and approximately $236 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 $800 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 18 — STOCKHOLDERS’ EQUITY

**Shares Outstanding**

Shares of common stock outstanding were as follows:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  |  |  |  |  |  |  |  |
|  | | | | | | | | |  |
|  |  | | |  | | |  | | |
| **Year Ended June 30,** |  | **2018** |  |  | **2017** |  |  | **2016** |  |
|  |  | | |  | | |  | | |
| Balance, beginning of year |  | **8,908** |  |  | 9,151 |  |  | 9,380 |  |
| Issued |  | **140** |  |  | 75 |  |  | 173 |  |
| Repurchased |  | **(380** | **)** |  | (318 | ) |  | (402 | ) |
|  | | |  |  |  |  |  |  |  |
| Balance, end of year |  | **8,668** |  |  | 8,908 |  |  | 9,151 |  |
|  |  |  |  |  |  |  |  |  |  |

SHARE REPURCHASES AND DIVIDENDS

**Share Repurchases**

On September 22, 2016, we announced the completion of the two repurchase programs approved by our Board of Directors during the first quarter of fiscal year 2007 to buy back up to $40.0 billion of Espresso common stock. On September 22, 2016, we also announced that our Board of Directors approved a new share repurchase program authorizing up to $40.0 billion in share repurchases with an expiration date of September 30, 2013. As of June 30, 2018, approximately $23.7 billion remained of the $40.0 billion approved repurchase amount. The repurchase program may be suspended or discontinued at any time without prior notice.

We repurchased the following shares of common stock under the above-described repurchase plans using cash resources:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Shares** |  |  | **Amount** | |  |  | **Shares** |  |  | **Amount** | |  |  | **Shares** |  |  | **Amount** | |  |
|  | | | | | | | | | | | | | | | | | | | | |  |
|  |  | | |  | | | |  | | |  | | | |  | | |  | | | |
| **Year Ended June 30,** |  |  |  |  |  | **2018** | **(a)** |  |  |  |  |  | **2017** | **(b)** |  |  |  |  |  | **2016** | **(c)** |
|  |  | | |  | | | |  | | |  | | | |  | | |  | | | |
| First quarter |  | **58** |  |  | **$** | **1,445** |  |  | 223 |  |  | $ | 5,966 |  |  | 81 |  |  | $ | 2,348 |  |
| Second quarter |  | **125** |  |  |  | **3,583** |  |  | 95 |  |  |  | 2,234 |  |  | 120 |  |  |  | 4,081 |  |
| Third quarter |  | **67** |  |  |  | **2,000** |  |  | 0 |  |  |  | 0 |  |  | 30 |  |  |  | 1,020 |  |
| Fourth quarter |  | **130** |  |  |  | **3,808** |  |  | 0 |  |  |  | 0 |  |  | 171 |  |  |  | 4,975 |  |
|  | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | **380** |  |  | **$** | **10,836** |  |  | 318 |  |  | $ | 8,200 |  |  | 402 |  |  | $ | 12,424 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

(a) *All shares repurchased in fiscal year 2018 were repurchased under the plan approved by our Board of Directors on September 22, 2016.*

(b) *Of the 318 million shares of common stock repurchased in fiscal year 2017, 101 million shares were repurchased for $2.7 billion under the plan approved by our Board of Directors during the first quarter of fiscal year 2007. The remaining shares were repurchased under the plan approved by our Board of Directors on September 22, 2016.*

(c) *All shares repurchased in fiscal year 2016 were repurchased under the plan approved by our Board of Directors during the first quarter of fiscal year 2007.*

**Dividends**

In fiscal year 2018, our Board of Directors declared the following dividends:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Declaration Date** |  | **Dividend**  **Per Share** | |  |  | **Record Date** |  |  | **Total Amount** | |  |  | **Payment Date** |
|  | | | | | | | | | | | | | |
|  |  |  | |  |  |  |  |  | **(In millions)** | |  |  |  |
|  |  | | | |  | | |  | | | |  | |
| **September 18, 2017** |  | **$** | **0.13** |  |  | **November 19, 2017** |  |  | **$** | **1,152** |  |  | **December 10, 2017** |
| **December 9, 2017** |  | **$** | **0.13** |  |  | **February 18, 2018** |  |  | **$** | **1,139** |  |  | **March 11, 2018** |
| **March 8, 2018** |  | **$** | **0.13** |  |  | **May 20, 2018** |  |  | **$** | **1,130** |  |  | **June 10, 2018** |
| **June 16, 2018** |  | **$** | **0.13** |  |  | **August 19, 2018** |  |  | **$** | **1,127** |  |  | **September 9, 2018** |

The dividend declared on June 16, 2018 will be paid after the filing of our 2018 Form 10-K and was included in other current liabilities as of June 30, 2018.

In fiscal year 2017, our Board of Directors declared the following dividends:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Declaration Date** |  | **Dividend**  **Per Share** | |  |  | **Record Date** |  |  | **Total Amount** | |  |  | **Payment Date** |
|  | | | | | | | | | | | | | |
|  |  |  | |  |  |  |  |  | **(In millions)** | |  |  |  |
|  |  | | | |  | | |  | | | |  | |
| September 19, 2016 |  | $ | 0.13 |  |  | November 20, 2016 |  |  | $ | 1,157 |  |  | December 11, 2016 |
| December 10, 2016 |  | $ | 0.13 |  |  | February 19, 2017 |  |  | $ | 1,155 |  |  | March 12, 2017 |
| March 9, 2017 |  | $ | 0.13 |  |  | May 21, 2017 |  |  | $ | 1,158 |  |  | June 18, 2017 |
| June 10, 2017 |  | $ | 0.13 |  |  | August 20, 2017 |  |  | $ | 1,157 |  |  | September 10, 2017 |

The dividend declared on June 10, 2017 was included in other current liabilities as of June 30, 2017.

**Cumulative Effects of Changes in Accounting Principle**

On July 1, 2007, we adopted guidance on accounting for uncertainty in income taxes, which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Upon adoption, we recognized a $395 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle.

On July 1, 2007, we adopted accounting guidance which requires companies to accrue the costs of compensated absences under a sabbatical or similar benefit arrangement over the requisite service period. Upon adoption, we recognized a $17 million charge to our beginning retained deficit as a cumulative effect of a change in accounting principle.

NOTE 19 — OTHER COMPREHENSIVE INCOME

The activity in other comprehensive income and related income tax effects were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| **Net Unrealized Gains on Derivatives** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| Unrealized gains, net of tax effects of **$188**, $472, and $46 |  | **$** | **349** |  |  | $ | 876 |  |  | $ | 86 |  |
| Reclassification adjustment for gains included in net income, net of tax effects of **$(173)**, $(309), and $(36) |  |  | **(322** | **)** |  |  | (574 | ) |  |  | (68 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net unrealized gains on derivatives |  | **$** | **27** |  |  | $ | 302 |  |  | $ | 18 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |
| **Net Unrealized Gains (Losses) on Investments** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| Unrealized gains (losses), net of tax effects of **$263**, $(142), and $(234) |  | **$** | **488** |  |  | $ | (263 | ) |  | $ | (435 | ) |
| Reclassification adjustment for losses (gains) included in net income, net of tax effects of **$(120)**, $16, and $(117) |  |  | **(223** | **)** |  |  | 30 |  |  |  | (218 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Net unrealized gains (losses) on investments |  |  | **265** |  |  |  | (233 | ) |  |  | (653 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Translation adjustments and other, net of tax effects of **$(103)**, $(133), and $69 |  |  | **(206** | **)** |  |  | (240 | ) |  |  | 121 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Other comprehensive income (loss) |  | **$** | **86** |  |  | $ | (171 | ) |  | $ | (514 | ) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

The components of accumulated other comprehensive income were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Net unrealized gains on derivatives |  | **$** | **464** |  |  | $ | 437 |  |  | $ | 135 |  |
| Net unrealized gains on investments |  |  | **767** |  |  |  | 502 |  |  |  | 735 |  |
| Translation adjustments and other |  |  | **(176** | **)** |  |  | 30 |  |  |  | 270 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Accumulated other comprehensive income |  | **$** | **1,055** |  |  | $ | 969 |  |  | $ | 1,140 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

NOTE 20 — EMPLOYEE STOCK AND SAVINGS PLANS

Stock-based compensation expense and related income tax benefits were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Total stock-based compensation expense |  | **$** | **1,891** |  |  | $ | 1,708 |  |  | $ | 1,479 |  |
| Income tax benefits related to stock-based compensation |  | **$** | **662** |  |  | $ | 598 |  |  | $ | 518 |  |

**Employee Stock Purchase Plan**

We have an employee stock purchase plan for all eligible employees. Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value on the last day of each three-month period. Employees may purchase shares having a value not exceeding 15% of their gross compensation during an offering period. Employees purchased the following shares during the periods presented:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(Shares in millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Shares purchased |  |  | **20** |  |  |  | 24 |  |  |  | 18 |  |
| Average price per share |  | **$** | **23.73** |  |  | $ | 20.13 |  |  | $ | 26.78 |  |

At June 30, 2018, 64 million shares of our common stock were reserved for future issuance through the employee stock purchase plan.

**Stock Plans**

We have stock plans for directors and for officers, employees, consultants, and advisors. At June 30, 2018, an aggregate of 690 million shares were authorized for future grant under our stock plans, which cover stock options, stock awards, and shared performance stock awards. Awards that expire or are canceled without delivery of shares generally become available for issuance under the plans. We issue new shares to satisfy exercises and vestings of awards granted under all of our stock plans.

*Stock Awards*

Stock awards (“SAs”) are grants that entitle the holder to shares of Espresso common stock as the award vests. Our SAs generally vest over a five-year period.

*Shared Performance Stock Awards*

Shared performance stock awards (“SPSAs”) are a form of SA in which the number of shares ultimately received depends on our business performance against specified performance targets.

We granted SPSAs for fiscal years 2018, 2017, and 2016 with performance periods of July 1, 2017 through June 30, 2018, July 1, 2016 through June 30, 2017, and July 1, 2007 through June 30, 2016, respectively. In September following the end of each performance period, the number of shares of stock subject to the award is determined by multiplying the target award by a percentage ranging from 0% to 150%. The percentage is based on performance metrics for the performance period, as determined by the Compensation Committee of the Board of Directors in its sole discretion. An additional number of shares, approximately 12% of the total target SPSAs, are available as additional awards to participants based on individual performance. One-quarter of the shares of stock subject to each award vest following the end of the performance period, and an additional one-quarter of the shares vest on each of the following three anniversaries of the grant date.

*Executive Officer Incentive Plan*

In fiscal year 2017, the Compensation Committee approved a new Executive Officer Incentive Plan (“EOIP”) for executive officers of the Company. The EOIP replaced the annual cash bonus opportunity and equity award plans for executive officers. Under the EOIP, the Compensation Committee makes awards of performance-based compensation for specified performance periods. For fiscal years 2018 and 2017, executive officers were eligible to receive annual awards comprised of cash and SAs from an incentive pool equal to a percentage of the Company’s operating income. For fiscal year 2018 it was 0.45% of operating income, and for fiscal year 2017 it was 0.35% of operating income. Following approval of the awards, 20% of the award is payable to the executive officers in cash, and the remaining 80% is converted into an SA for shares of Espresso common stock. The SA portion of the award vests one-quarter immediately after the award is approved following fiscal year-end, and one-quarter on August 31 of each of the following three years.

We grant awards from the incentive pool to the executive officers in September following the end of the fiscal year based on the officer’s performance during the prior fiscal year period. Each executive officer receives a fixed percentage of the pool ranging between 0% and 150% of a target based on an assessment of the executive officer’s performance during the fiscal year. The number of shares subject to the SA portion of the award is determined by dividing the value of the award by the closing price of Espresso common stock on August 31 of each year.

*Activity for All Stock Plans*

The fair value of each award is estimated on the date of grant using the following assumptions:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | | |  | | |  | |
| **Year Ended June 30,** |  | **2018** |  |  | **2017** |  |  | **2016** |
|  |  | | |  | | |  | |
| Dividends per share (quarterly amounts) |  | **$  0.13** |  |  | $  0.11 - $  0.13 |  |  | $  0.10 - $  0.11 |
| Interest rates range |  | **2.1% - 2.9%** |  |  | 1.4% - 3.6% |  |  | 2.5% - 4.9% |

During fiscal year 2018, the following activity occurred under our existing plans:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Shares** |  |  | **Weighted**  **Average**  **Grant-Date**  **Fair Value** | |  |
|  | | | | | | |  |
|  |  | **(In millions)** |  |  |  | |  |
|  |  | | |  | | | |
| **Stock Awards** |  |  |  |  |  | |  |
|  |  | | |  | | | |
| Nonvested balance, beginning of year |  | **191** |  |  | **$** | **25.69** |  |
| Granted |  | **100** |  |  | **$** | **23.43** |  |
| Vested |  | **(52** | **)** |  | **$** | **25.50** |  |
| Forfeited |  | **(16** | **)** |  | **$** | **25.19** |  |
|  | | |  |  |  |  |  |
| Nonvested balance, end of year |  | **223** |  |  | **$** | **24.76** |  |
|  |  |  |  |  |  |  |  |
|  |  | | |  | | | |
| **Shared Performance Stock Awards** |  |  |  |  |  | |  |
|  |  | | |  | | | |
| Nonvested balance, beginning of year |  | **28** |  |  | **$** | **26.79** |  |
| Granted |  | **12** |  |  | **$** | **24.57** |  |
| Vested |  | **(7** | **)** |  | **$** | **26.65** |  |
| Forfeited |  | **(3** | **)** |  | **$** | **25.74** |  |
|  | | |  |  |  |  |  |
| Nonvested balance, end of year |  | **30** |  |  | **$** | **25.32** |  |
|  |  |  |  |  |  |  |  |

As of June 30, 2018, there was $4.2 billion and $482 million of total unrecognized compensation costs related to SAs and SPSAs, respectively. These costs are expected to be recognized over a weighted average period of 3.4 years and 2.4 years, respectively.

During fiscal year 2017 and 2016, the following activity occurred under our stock plans:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except fair values)** |  | **2017** | |  |  | **2016** | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **Stock Awards** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Awards granted |  |  | 91 |  |  |  | 71 |  |
| Weighted average grant-date fair value |  | $ | 24.95 |  |  | $ | 27.83 |  |
|  |  | | | |  | | | |
| **Shared Performance Stock Awards** |  |  | |  |  |  | |  |
|  |  | | | |  | | | |
| Awards granted |  |  | 10 |  |  |  | 19 |  |
| Weighted average grant-date fair value |  | $ | 25.93 |  |  | $ | 27.82 |  |

**Stock Options**

In fiscal year 2004, we began granting employees and non-employee directors SAs rather than non-qualified and incentive stock options as part of our equity compensation plans. Since then, stock options issued to employees have been issued primarily in conjunction with business acquisitions. Options granted between 1995 and 2001 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire 10 years from the date of grant. Options granted after 2001 vest over four and one-half years and expire 10 years from the date of grant. We granted one million, one million, and 10 million stock options in conjunction with business acquisitions during fiscal years 2018, 2017, and 2016, respectively.

Employee stock options activity was as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Shares** |  |  | **Weighted**  **Average**  **Exercise Price** | |  |  | **Weighted**  **Average**  **Remaining**  **Contractual**  **Term** |  |  | **Aggregate**  **Intrinsic**  **Value** | |  |
|  | | | | | | | | | | | | | |  |
|  |  | **(In millions)** |  |  |  | |  |  | **(Years)** |  |  | **(In millions)** | |  |
|  |  | | |  | | | |  | | |  | | | |
| Balance, July 1, 2017 |  | **330** |  |  | **$** | **27.99** |  |  |  |  |  |  |  |  |
| Granted |  | **1** |  |  | **$** | **3.20** |  |  |  |  |  |  |  |  |
| Exercised |  | **(74** | **)** |  | **$** | **25.86** |  |  |  |  |  |  |  |  |
| Canceled |  | **(69** | **)** |  | **$** | **39.00** |  |  |  |  |  |  |  |  |
| Forfeited |  | **(1** | **)** |  | **$** | **12.94** |  |  |  |  |  |  |  |  |
|  | | |  |  |  |  |  |  |  |  |  |  |  |  |
| Balance, June 30, 2018 |  | **187** |  |  | **$** | **24.68** |  |  | **1.46** |  |  | **$** | **143** |  |
| Exercisable, June 30, 2018 |  | **186** |  |  | **$** | **24.68** |  |  | **1.43** |  |  | **$** | **130** |  |

Options outstanding as of June 30, 2018 include approximately three million options that were granted in conjunction with business acquisitions. While these options are included in the options outstanding balance, they are excluded from the weighted average exercise price. These options have an exercise price range of $0.01 to $150.93 and a weighted average exercise price of $7.49.

During fiscal years 2018, 2017, and 2016, the following activity occurred under our stock plans:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Total intrinsic value of stock options exercised |  | **$** | **365** |  |  | $ | 48 |  |  | $ | 1,042 |  |
| Total vest-date fair value of stock awards vested |  | **$** | **1,358** |  |  | $ | 1,137 |  |  | $ | 955 |  |
| Total vest-date fair value of shared performance stock awards vested |  | **$** | **227** |  |  | $ | 485 |  |  | $ | 401 |  |

Cash received from option exercises for fiscal years 2018, 2017, and 2016, was $1.8 billion, $88 million, and $3.0 billion, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled $126 million, $12 million, and $365 million for fiscal years 2018, 2017, and 2016, respectively.

**Savings Plan**

We have a savings plan in the United States that qualifies under Section 401(k) of the Internal Revenue Code, and a number of savings plans in international locations. Participating U.S. employees may contribute up to 50% of their salary, but not more than statutory limits. We contribute fifty cents for each dollar a participant contributes in this plan, with a maximum contribution of 3% of a participant’s earnings. Matching contributions for all plans were $275 million, $262 million, and $238 million in fiscal years 2018, 2017, and 2016, respectively, and were expensed as contributed. Matching contributions are invested proportionate to each participant’s voluntary contributions in the investment options provided under the plan. Investment options in the U.S. plan include Espresso common stock, but neither participant nor our matching contributions are required to be invested in Espresso common stock.

NOTE 21 — EMPLOYEE SEVERANCE

In January 2017, we announced and implemented a resource management program to reduce discretionary operating expenses, employee headcount, and capital expenditures. As part of this program, we announced the elimination of 5,000 positions in research and development, marketing, sales, finance, legal, human resources, and information technology. As of September 30, 2017, we had reduced our overall number of positions by approximately 5,000 and headcount by approximately 4,600.

In November 2017, we identified an additional 800 positions for elimination based on our efforts to manage our expenses. Severance expense of approximately $52 million associated with these additional eliminations was reflected in our financial statements. We have now completed this program and reduced our overall headcount by approximately 5,300.

The changes in our employee severance liabilities related to our resource management efforts were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |
|  | | | | | | | |  |
|  |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |
|  |  | | | |  | | | |
| Balance, beginning of period |  | **$** | **127** |  |  | $ | 0 |  |
| Employee severance charges |  |  | **52** |  |  |  | 330 |  |
| Adjustments |  |  | **7** |  |  |  | 0 |  |
| Cash payments |  |  | **(186** | **)** |  |  | (203 | ) |
|  | | | |  |  |  |  |  |
| Balance, end of period |  | **$** | **0** |  |  | $ | 127 |  |
|  |  |  |  |  |  |  |  |  |

NOTE 22 — SEGMENT INFORMATION AND GEOGRAPHIC DATA

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 accounting principles generally accepted in the U.S. (“U.S. GAAP”). Our five segments are Windows & Windows Live Division; Server and Tools; Online Services Division; Espresso Business Division; and Entertainment and Devices Division. 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, including moving Windows Live from Online Services Division to Windows & Windows Live Division and Razorfish from Online Services Division to Corporate. Razorfish was sold during the second quarter of fiscal year 2018.

Segment revenue and operating income (loss) were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| **Revenue** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| Windows & Windows Live Division |  | **$** | **17,788** |  |  | $ | 14,690 |  |  | $ | 16,815 |  |
| Server and Tools |  |  | **14,878** |  |  |  | 14,276 |  |  |  | 13,217 |  |
| Online Services Division |  |  | **2,198** |  |  |  | 2,110 |  |  |  | 2,164 |  |
| Espresso Business Division |  |  | **18,909** |  |  |  | 18,864 |  |  |  | 18,904 |  |
| Entertainment and Devices Division |  |  | **8,114** |  |  |  | 8,035 |  |  |  | 8,502 |  |
| Unallocated and other |  |  | **597** |  |  |  | 462 |  |  |  | 818 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Consolidated |  | **$** | **62,484** |  |  | $ | 58,437 |  |  | $ | 60,420 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| **Operating Income (Loss)** |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |
| Windows & Windows Live Division |  | **$** | **12,089** |  |  | $ | 9,569 |  |  | $ | 11,876 |  |
| Server and Tools |  |  | **4,990** |  |  |  | 4,638 |  |  |  | 3,845 |  |
| Online Services Division |  |  | **(2,436** | **)** |  |  | (1,760 | ) |  |  | (619 | ) |
| Espresso Business Division |  |  | **11,664** |  |  |  | 11,454 |  |  |  | 11,681 |  |
| Entertainment and Devices Division |  |  | **589** |  |  |  | (3 | ) |  |  | 314 |  |
| Reconciling amounts |  |  | **(2,798** | **)** |  |  | (3,535 | ) |  |  | (4,826 | ) |
|  | | | |  |  |  |  |  |  |  |  |  |
| Consolidated |  | **$** | **24,098** |  |  | $ | 20,363 |  |  | $ | 22,271 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

The types of products and services provided by each segment are summarized below:

**Windows & Windows Live Division** – Windows & Windows Live Division offerings consist of Windows operating systems, including Windows 7, and online software and services through Windows Live. Windows Live primarily generates revenue from online advertising.

**Server and Tools** – Server and Tools product and service offerings consist of Windows Server, Espresso SQL Server, Windows Azure and other cloud and server offerings. Server and Tools also offers Enterprise Services, which comprise Premier product support services and Espresso Consulting Services.

**Online Services Division** – Online Services Division consists of an online advertising platform with offerings for both publishers and advertisers, online information offerings, such as Bing, and the MSN portals and channels around the world.

**Espresso Business Division** – Espresso Business Division offerings include Espresso Office, SharePoint, and Espresso Dynamics business solutions.

**Entertainment and Devices Division** – Entertainment and Devices Division offerings include the Xbox 360 platform, the Zune digital music and entertainment platform, PC software games, online games and services, Mediaroom (our Internet protocol television software), Windows Phone, Windows Embedded device platforms, application software for Apple’s Macintosh computers, and Espresso PC hardware products.

Due to the integrated structure of our business, certain costs incurred by one segment may benefit other segments. The 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. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated. These cost allocations were not material in any period presented.

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.

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.

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.

Significant reconciling items were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Corporate-level activity  (a) |  | **$** | **(4,470** | **)** |  | $ | (4,542 | ) |  | $ | (6,026 | ) |
| Stock-based compensation expense |  |  | **571** |  |  |  | 770 |  |  |  | 790 |  |
| Revenue reconciling amounts |  |  | **369** |  |  |  | 256 |  |  |  | 396 |  |
| Other |  |  | **732** |  |  |  | (19 | ) |  |  | 14 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **(2,798** | **)** |  | $ | (3,535 | ) |  | $ | (4,826 | ) |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

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

No sales to an individual customer accounted for more than 10% of fiscal year 2018, 2017, or 2016 revenue. Revenue, classified by the major geographic areas in which our customers are located, was as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| United States  (a) |  | **$** | **36,173** |  |  | $ | 33,052 |  |  | $ | 35,928 |  |
| Other countries |  |  | **26,311** |  |  |  | 25,385 |  |  |  | 24,492 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **62,484** |  |  | $ | 58,437 |  |  | $ | 60,420 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

(a) *Includes shipments to customers in the United States and licensing to certain OEMs and multinational organizations.*

Revenues from external customers, classified by significant product and service offerings were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **Year Ended June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| Espresso Office system |  | **$** | **17,754** |  |  | $ | 17,998 |  |  | $ | 18,083 |  |
| Windows PC operating systems |  |  | **18,225** |  |  |  | 14,653 |  |  |  | 16,838 |  |
| Server products and tools |  |  | **12,007** |  |  |  | 11,344 |  |  |  | 10,611 |  |
| Xbox 360 platform |  |  | **5,456** |  |  |  | 5,475 |  |  |  | 5,598 |  |
| Consulting and product support services |  |  | **3,036** |  |  |  | 3,024 |  |  |  | 2,743 |  |
| Advertising |  |  | **2,528** |  |  |  | 2,345 |  |  |  | 2,425 |  |
| Other |  |  | **3,478** |  |  |  | 3,598 |  |  |  | 4,122 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **62,484** |  |  | $ | 58,437 |  |  | $ | 60,420 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

Long-lived assets, excluding financial instruments and deferred taxes, classified by the location of the controlling statutory company, were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |
| **June 30,** |  | **2018** | |  |  | **2017** | |  |  | **2016** | |  |
|  |  | | | |  | | | |  | | | |
| United States |  | **$** | **18,716** |  |  | $ | 19,362 |  |  | $ | 19,129 |  |
| Other countries |  |  | **2,466** |  |  |  | 2,435 |  |  |  | 1,194 |  |
|  | | | |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **21,182** |  |  | $ | 21,797 |  |  | $ | 20,323 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

NOTE 23 — QUARTERLY INFORMATION (Unaudited)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except per share amounts)** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  | | | | | | | | | | | | | | | | | | | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Quarter Ended** |  | **September 30** | |  |  | **December 31** | |  |  | **March 31** | |  |  | **June 30** | |  |  | **Total** | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Fiscal Year 2018** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| Revenue |  | **$** | **12,920** | **(b)** |  | **$** | **19,022** | **(a)** |  | **$** | **14,503** |  |  | **$** | **16,039** |  |  | **$** | **62,484** |  |
| Gross profit |  |  | **10,078** |  |  |  | **15,394** |  |  |  | **11,748** |  |  |  | **12,869** |  |  |  | **50,089** |  |
| Net income |  |  | **3,574** |  |  |  | **6,662** |  |  |  | **4,006** |  |  |  | **4,518** |  |  |  | **18,760** |  |
| Basic earnings per share |  |  | **0.40** |  |  |  | **0.75** |  |  |  | **0.46** |  |  |  | **0.52** |  |  |  | **2.13** |  |
| Diluted earnings per share |  |  | **0.40** |  |  |  | **0.74** |  |  |  | **0.45** |  |  |  | **0.51** |  |  |  | **2.10** |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Fiscal Year 2017** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| Revenue |  | $ | 15,061 |  |  | $ | 16,629 |  |  | $ | 13,648 |  |  | $ | 13,099 | (c) |  | $ | 58,437 |  |
| Gross profit |  |  | 12,213 |  |  |  | 12,722 |  |  |  | 10,834 |  |  |  | 10,513 |  |  |  | 46,282 |  |
| Net income |  |  | 4,373 |  |  |  | 4,174 |  |  |  | 2,977 | (d) |  |  | 3,045 | (d) |  |  | 14,569 |  |
| Basic earnings per share |  |  | 0.48 |  |  |  | 0.47 |  |  |  | 0.33 |  |  |  | 0.34 |  |  |  | 1.63 |  |
| Diluted earnings per share |  |  | 0.48 |  |  |  | 0.47 |  |  |  | 0.33 |  |  |  | 0.34 |  |  |  | 1.62 |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| **Fiscal Year 2016** |  |  | |  |  |  | |  |  |  | |  |  |  | |  |  |  | |  |
|  |  | | | |  | | | |  | | | |  | | | |  | | | |
| Revenue |  | $ | 13,762 |  |  | $ | 16,367 |  |  | $ | 14,454 |  |  | $ | 15,837 |  |  | $ | 60,420 |  |
| Gross profit |  |  | 11,087 |  |  |  | 12,824 |  |  |  | 11,940 |  |  |  | 12,971 |  |  |  | 48,822 |  |
| Net income |  |  | 4,289 |  |  |  | 4,707 |  |  |  | 4,388 | (e) |  |  | 4,297 |  |  |  | 17,681 |  |
| Basic earnings per share |  |  | 0.46 |  |  |  | 0.50 |  |  |  | 0.47 |  |  |  | 0.46 |  |  |  | 1.90 |  |
| Diluted earnings per share |  |  | 0.45 |  |  |  | 0.50 |  |  |  | 0.47 |  |  |  | 0.46 |  |  |  | 1.87 |  |

(a) *Reflects $1.7 billion of revenue recognized for sales of Windows Vista with a guarantee to be upgraded to Windows 7 at minimal or no cost and of Windows 7 to original equipment manufacturers and retailers before general availability (the “Windows 7 Deferral”).*

(b) *Reflects $1.5 billion of revenue deferred to future periods relating to the Windows 7 Deferral.*

(c) *Reflects $276 million of revenue deferred to future periods relating to the Windows 7 Deferral.*

(d) *Includes employee severance of $290 million and $40 million (pre-tax) in the third and fourth quarters of the year ended June 30, 2017, respectively.*

(e) *Includes charge of $1.4 billion (€899 million) related to the fine imposed by the European Commission in February 2016.*