ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,	**2016**	**2015**	**2014**
Revenue:			
Product	**$ 61,502**	$ 75,956	$ 72,948
Service and other	**23,818**	17,624	13,885
Total revenue	**85,320**	93,580	86,833
Cost of revenue:			
Product	**17,880**	21,410	16,681
Service and other	**14,900**	11,628	10,397
Total cost of revenue	**32,780**	33,038	27,078
Gross margin	**52,540**	60,542	59,755
Research and development	**11,988**	12,046	11,381
Sales and marketing	**14,697**	15,713	15,811
General and administrative	**4,563**	4,611	4,677
Impairment, integration, and restructuring	**1,110**	10,011	127
Operating income	**20,182**	18,161	27,759
Other income (expense), net	**(431)**	346	61
Income before income taxes	**19,751**	18,507	27,820
Provision for income taxes	**2,953**	6,314	5,746
Net income	**$ 16,798**	$ 12,193	$ 22,074
Earnings per share:			
Basic	**$ 2.12**	$ 1.49	$ 2.66
Diluted	**$ 2.10**	$ 1.48	$ 2.63
Weighted average shares outstanding:			
Basic	**7,925**	8,177	8,299
Diluted	**8,013**	8,254	8,399
Cash dividends declared per common share	**$ 1.44**	$ 1.24	$ 1.12

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions)

Year Ended June 30,	**2016**	**2015**	**2014**
Net income	**$ 16,798**	$ 12,193	$ 22,074
Other comprehensive income (loss):			
Net unrealized gains (losses) on derivatives (net of tax effects of **$(12)**, $20, and $(4))	**(238)**	559	(35)
Net unrealized gains (losses) on investments (net of tax effects of **$(121)**, $(197), and $936)	**(228)**	(362)	1,737
Translation adjustments and other (net of tax effects of **$(33)**, $16, and $12)	**(519)**	(1,383)	263
Other comprehensive income (loss)	**(985)**	(1,186)	1,965
Comprehensive income	**$ 15,813**	$ 11,007	$ 24,039

See accompanying notes.

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BALANCE SHEETS

(In millions)

June 30,	2016	2015
Assets		
Current assets:		
Cash and cash equivalents	**$ 6,510**	$ 5,595
Short-term investments (including securities loaned of **$204** and $75)	**106,730**	90,931
Total cash, cash equivalents, and short-term investments	**113,240**	96,526
Accounts receivable, net of allowance for doubtful accounts of **$426** and $335	**18,277**	17,908
Inventories	**2,251**	2,902
Other	**5,892**	5,461
Total current assets	**139,660**	122,797
Property and equipment, net of accumulated depreciation of **$19,800** and $17,606	**18,356**	14,731
Equity and other investments	**10,431**	12,053
Goodwill	**17,872**	16,939
Intangible assets, net	**3,733**	4,835
Other long-term assets	**3,642**	3,117
Total assets	**$ 193,694**	$ 174,472
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	**$ 6,898**	$ 6,591
Short-term debt	**12,904**	4,985
Current portion of long-term debt	**0**	2,499
Accrued compensation	**5,264**	5,096
Income taxes	**580**	606
Short-term unearned revenue	**27,468**	23,223
Securities lending payable	**294**	92
Other	**5,949**	6,555
Total current liabilities	**59,357**	49,647
Long-term debt	**40,783**	27,808
Long-term unearned revenue	**6,441**	2,095
Deferred income taxes	**1,476**	1,295
Other long-term liabilities	**13,640**	13,544
Total liabilities	**121,697**	94,389
Commitments and contingencies		
Stockholders’ equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding **7,808** and 8,027	**68,178**	68,465
Retained earnings	**2,282**	9,096
Accumulated other comprehensive income	**1,537**	2,522
Total stockholders’ equity	**71,997**	80,083
Total liabilities and stockholders’ equity	**$ 193,694**	$ 174,472

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30,	**2016**	**2015**	**2014**
Operations			
Net income	**$ 16,798**	$ 12,193	$ 22,074
Adjustments to reconcile net income to net cash from operations:			
Goodwill and asset impairments	**630**	7,498	0
Depreciation, amortization, and other	**6,622**	5,957	5,212
Stock-based compensation expense	**2,668**	2,574	2,446
Net recognized gains on investments and derivatives	**(223)**	(443)	(109)
Deferred income taxes	**332**	224	(331)
Deferral of unearned revenue	**57,072**	45,072	44,325
Recognition of unearned revenue	**(48,498)**	(44,920)	(41,739)
Changes in operating assets and liabilities:			
Accounts receivable	**(530)**	1,456	(1,120)
Inventories	**600**	(272)	(161)
Other current assets	**(1,167)**	62	(29)
Other long-term assets	**(41)**	346	(628)
Accounts payable	**88**	(1,054)	473
Other current liabilities	**(260)**	(624)	1,075
Other long-term liabilities	**(766)**	1,599	1,014
Net cash from operations	**33,325**	29,668	32,502
Financing			
Proceeds from issuance of short-term debt, maturities of 90 days or less, net	**7,195**	4,481	500
Proceeds from issuance of debt	**13,884**	10,680	10,350
Repayments of debt	**(2,796)**	(1,500)	(3,888)
Common stock issued	**668**	634	607
Common stock repurchased	**(15,969)**	(14,443)	(7,316)
Common stock cash dividends paid	**(11,006)**	(9,882)	(8,879)
Other	**(369)**	362	(39)
Net cash used in financing	**(8,393)**	(9,668)	(8,665)
Investing			
Additions to property and equipment	**(8,343)**	(5,944)	(5,485)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(1,393)**	(3,723)	(5,937)
Purchases of investments	**(129,758)**	(98,729)	(72,690)
Maturities of investments	**22,054**	15,013	5,272
Sales of investments	**93,287**	70,848	60,094
Securities lending payable	**203**	(466)	(87)
Net cash used in investing	**(23,950)**	(23,001)	(18,833)
Effect of foreign exchange rates on cash and cash equivalents	**(67)**	(73)	(139)
Net change in cash and cash equivalents	**915**	(3,074)	4,865
Cash and cash equivalents, beginning of period	**5,595**	8,669	3,804
Cash and cash equivalents, end of period	**$ 6,510**	$ 5,595	$ 8,669

See accompanying notes.

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STOCKHOLDERS' EQUITY STATEMENTS

(In millions)

Year Ended June 30,	2016	2015	2014
Common stock and paid-in capital			
Balance, beginning of period	**$ 68,465**	$ 68,366	$ 67,306
Common stock issued	**668**	634	607
Common stock repurchased	**(3,689)**	(3,700)	(2,328)
Stock-based compensation expense	**2,668**	2,574	2,446
Stock-based compensation income tax benefits	**0**	588	272
Other, net	**66**	3	63
Balance, end of period	**68,178**	68,465	68,366
Retained earnings			
Balance, beginning of period	**9,096**	17,710	9,895
Net income	**16,798**	12,193	22,074
Common stock cash dividends	**(11,329)**	(10,063)	(9,271)
Common stock repurchased	**(12,283)**	(10,744)	(4,988)
Balance, end of period	**2,282**	9,096	17,710
Accumulated other comprehensive income			
Balance, beginning of period	**2,522**	3,708	1,743
Other comprehensive income (loss)	**(985)**	(1,186)	1,965
Balance, end of period	**1,537**	2,522	3,708
Total stockholders' equity	**$ 71,997**	$ 80,083	$ 89,784

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

NOTE 1 — ACCOUNTING POLICIES

Accounting Principles

The consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP").

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

Principles of Consolidation

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

Segment Information

In June 2015, we announced a change in organizational structure to align to our strategic direction as a productivity and platform company. During the first quarter of fiscal year 2016, our chief operating decision maker, who is also our Chief Executive Officer, requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. As a result, beginning in fiscal year 2016, we report our financial performance based on our new segments described in Note 21 – Segment Information and Geographic Data. We have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance during fiscal year 2016. This change primarily impacted Note 10 – Goodwill, Note 15 – Unearned Revenue, and Note 21 – Segment Information and Geographic Data, with no impact on consolidated net income or cash flows.

Estimates and Assumptions

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

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").

Product Revenue and Service and Other Revenue

Service revenue exceeded 10% of total revenue for the first time in fiscal year 2016. As a result, we have separately disclosed product revenue and service and other revenue on our consolidated income statements.

Product revenue includes sales from operating systems; cross-device productivity applications; server applications; business solution applications; desktop and server management tools; software development tools; video games; hardware such as PCs, tablets, gaming and entertainment consoles, phones, other intelligent devices, and related accessories; and training and certification of computer system integrators and developers.

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

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is probable. Revenue generally is recognized net of allowances for returns and any taxes collected from customers and subsequently remitted to governmental authorities.

Revenue recognition for multiple-element arrangements requires judgment to determine if multiple elements exist, whether elements can be accounted for as separate units of accounting, and if so, the fair value for each of the elements.

Microsoft enters into arrangements that can include various combinations of software, services, and hardware. Where elements are delivered over different periods of time, and when allowed under U.S. GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement, and revenue is recognized as each element is delivered. We use a hierarchy to determine the fair value to be used for allocating revenue to elements: (i) vendor-specific objective evidence of fair value (“VSOE”), (ii) third-party evidence, and (iii) best estimate of selling price (“ESP”). For software elements, we follow the industry specific software guidance which only allows for the use of VSOE in establishing fair value. Generally, VSOE is the price charged when the deliverable is sold separately or the price established by management for a product that is not yet sold if it is probable that the price will not change before introduction into the marketplace. ESPs are established as best estimates of what the selling prices would be if the deliverables were sold regularly on a stand-alone basis. Our process for determining ESPs requires judgment and considers multiple factors that may vary over time depending upon the unique facts and circumstances related to each deliverable.

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.

Technology guarantee programs are accounted for as multiple-element arrangements as customers receive free or significantly discounted rights to use upcoming new versions of a software product if they license existing versions of the product during the eligibility period. Revenue is allocated between the 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 the VSOE of fair value of the products. The VSOE of fair value for upcoming new products are based on the price determined by management having the relevant authority when the element is not yet sold separately, but is expected to be sold in the near future at the price set by management.

Software updates that will be provided free of charge are evaluated on a case-by-case basis to determine whether they meet the definition of an upgrade and create a multiple-element arrangement, which may require revenue to be deferred and recognized when the upgrade is delivered, or if it is determined that implied post-contract customer support (“PCS”) is being provided, the arrangement is accounted for as a multiple-element arrangement and all revenue from the arrangement is deferred and recognized over the implied PCS term when the VSOE of fair value does not exist. If updates are determined to not meet the definition of an upgrade, revenue is generally recognized as products are shipped or made available.

Customers purchasing a Windows 10 license will receive unspecified updates and upgrades over the life of their Windows 10 device at no additional cost. As these updates and upgrades will not be sold on a stand-alone basis, we are unable to establish VSOE of fair value. Accordingly, revenue from licenses of Windows 10 is recognized ratably over the estimated life of the related device, which ranges between two to four years.

Certain volume licensing arrangements include a perpetual license for current products combined with rights to receive unspecified future versions of software products, which we have determined are additional software products and are therefore accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period. Arrangements that include term-based licenses for current products with the right to use unspecified future versions of the software during the coverage period, are also accounted for as subscriptions, with revenue recognized ratably over the coverage period. Revenue from cloud-based services arrangements that allow for the use of a hosted software product or service over a contractually determined period of time without taking possession of software are accounted for as subscriptions with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period beginning on the date the service is made available to customers. Revenue from cloud-based services arrangements that are provided on a consumption basis (for example, the amount of storage used in a particular period) is recognized commensurate with the customer utilization of such resources.

Some volume licensing arrangements include time-based subscriptions for cloud-based services and software offerings that are accounted for as subscriptions. These arrangements are considered multiple-element arrangements. However, because all elements are accounted for as subscriptions and have the same coverage period and delivery pattern, they have the same revenue recognition timing.

Revenue related to Microsoft Surface (“Surface”) devices, Xbox consoles, games published by us, phones, and other hardware components is generally recognized when ownership is transferred to the resellers or to end customers when selling directly through Microsoft retail stores and online marketplaces. A portion of revenue may be deferred when these products are combined with software elements, and/or services. Revenue related to licensing for games published by third parties for use on the Xbox consoles 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.

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 websites, and to acquire online advertising space; costs incurred to support and maintain Internet-based products and services, including datacenter costs and royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized software development costs. Capitalized software 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 expense, 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, $1.9 billion, and $2.3 billion in fiscal years 2016, 2015, and 2014, respectively.

Stock-Based Compensation

Compensation cost for stock awards is measured at the fair value on the grant date and recognized as expense, net of estimated forfeitures, over the related service period using the straight-line method. The fair value of stock awards is based on the quoted price of our common stock on the grant date less the present value of expected dividends not received during the vesting period. Compensation expense for the employee stock purchase plan ("ESPP") 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 reinvested, 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. Deferred tax assets are reported net of a valuation allowance when it is more likely than not that a tax benefit will not be realized. All deferred income taxes are classified as long-term on our consolidated balance sheets.

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. government securities, 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, credit spreads, 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, common and preferred stock, mortgage- and asset-backed securities, U.S. government and agency securities, and foreign government bonds. 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 common and preferred stock, and goodwill and intangible assets, when they are recorded at fair value due to an impairment charge. Unobservable inputs used in the models are significant to the fair values of the assets and liabilities.

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

Our other current financial assets and our current financial liabilities have fair values that approximate their carrying values.

Financial Instruments

Investments

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 the market value of available-for-sale securities, 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. These transactions are accounted for as secured borrowings and the loaned securities continue to be carried as investments on our consolidated balance sheets. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash 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), net and a new cost basis in the investment is established.

Derivatives

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 derivative instruments designated as fair value hedges, the gains (losses) are recognized in earnings in the periods of change together with the offsetting losses (gains) on the hedged items 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 gains (losses) on the derivatives 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), net. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are reclassified from accumulated other comprehensive income (“AOCI”) into other income (expense), net.

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,	**2016**	**2015**	**2014**
Balance, beginning of period	**$ 335**	$ 301	$ 336
Charged to costs and other	**146**	77	16
Write-offs	**(55)**	(43)	(51)
Balance, end of period	**$ 426**	$ 335	$ 301

Inventories

Inventories are stated at average cost, subject to the lower of cost or market. 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 less accumulated depreciation, 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 to seven years; computer equipment, two to three years; buildings and improvements, five to 15 years; leasehold improvements, three to 20 years; and furniture and equipment, one to 10 years. Land is not depreciated.

Goodwill

Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value.

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 15 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.

Recent Accounting Guidance

Recently adopted accounting guidance

Improvements to Employee Share-Based Payment Accounting

In March 2016, the Financial Accounting Standards Board ("FASB") issued a new standard that changes the accounting for certain aspects of share-based payments to employees. The new guidance requires excess tax benefits and tax deficiencies to be recorded in the income statement when stock awards vest or are settled. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity apart from other income tax cash flows. The standard also allows us to repurchase more of an employee's vesting shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made to tax authorities on an employee's behalf for withheld shares should be presented as a financing activity on our cash flows statement, and provides an accounting policy election to account for forfeitures as they occur. The new standard is effective for us beginning July 1, 2017, with early adoption permitted.

We elected to early adopt the new guidance in the third quarter of fiscal year 2016 which requires us to reflect any adjustments as of July 1, 2015, the beginning of the annual period that includes the interim period of adoption. The primary impact of adoption was the recognition of excess tax benefits in our provision for income taxes rather than paid-in capital for all periods in fiscal year 2016. Additional amendments to the accounting for income taxes and minimum statutory withholding tax requirements had no impact to retained earnings as of July 1, 2015, where the cumulative effect of these changes are required to be recorded. We have elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost to be recognized in each period.

We elected to apply the presentation requirements for cash flows related to excess tax benefits retrospectively to all periods presented which resulted in an increase to both net cash from operations and net cash used in financing of $588 million and $271 million for the years ended June 30, 2015 and 2014, respectively. The presentation requirements for cash flows related to employee taxes paid for withheld shares had no impact to any of the periods presented on our consolidated cash flows statements since such cash flows have historically been presented as a financing activity.

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Adoption of the new standard resulted in the recognition of excess tax benefits in our provision for income taxes rather than paid-in capital of $402 million for the year ended June 30, 2016.

Balance Sheet Classification of Deferred Taxes

In November 2015, the FASB issued guidance that requires companies to classify all deferred tax assets and liabilities as noncurrent on the balance sheet rather than separately disclosing deferred taxes as current and noncurrent. This standard is effective for us beginning July 1, 2017, and can be early adopted and applied either prospectively or retrospectively to all periods presented upon adoption.

We elected to early adopt the new guidance in the fourth quarter of fiscal year 2016 on a retrospective basis. While the guidance changes the manner in which deferred taxes are classified on the balance sheet, we are still required to offset deferred tax assets and liabilities for each taxpaying component within a tax jurisdiction. Adoption of the new standard impacted our previously reported results as follows:

(In millions)		**June 30, 2015**
	As adjusted	**As reported**
Balance sheets:		
Current deferred income tax assets	**$ 0**	$ 1,915
Other long-term assets	**$ 3,117**	$ 2,953
Other current liabilities	**$ 6,555**	$ 6,766
Long-term deferred income tax liabilities	**$ 1,295**	$ 2,835

Recent accounting guidance not yet adopted

Financial Instruments – Credit Losses

In June 2016, the FASB issued a new standard to replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For trade and other receivables, loans, and other financial instruments, we will be required to use a forward-looking expected loss model rather than the incurred loss model for recognizing credit losses which reflects losses that are probable. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. The new standard will be effective for us beginning July 1, 2020, with early adoption permitted beginning July 1, 2019. Application of the amendments is through a cumulative-effect adjustment to retained earnings as of the effective date. We are currently evaluating the impact of this standard on our consolidated financial statements.

Leases

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

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

We anticipate this standard will have a material impact on our consolidated financial statements. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting for office, retail, and datacenter operating leases.

Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

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

Revenue from Contracts with Customers

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

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

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

We anticipate this standard will have a material impact on our consolidated financial statements. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting for software license revenue. We expect revenue related to hardware, cloud offerings, and professional services to remain substantially unchanged. Specifically, under the new standard we expect to recognize Windows 10 revenue predominantly at the time of billing rather than ratably over the life of the related device. We also expect to recognize license revenue at the time of billing rather than over the subscription period from certain multi-year commercial software subscriptions that include both software licenses and Software Assurance. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard will be dependent on contract-specific terms, and may vary in some instances from recognition at the time of billing.

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

NOTE 2 — EARNINGS PER SHARE

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

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The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)

Year Ended June 30,	2016	2015	2014
Net income available for common shareholders (A)	**$ 16,798**	$ 12,193	$ 22,074
Weighted average outstanding shares of common stock (B)	**7,925**	8,177	8,299
Dilutive effect of stock-based awards	**88**	77	100
Common stock and common stock equivalents (C)	**8,013**	8,254	8,399
Earnings Per Share			
Basic (A/B)	**$ 2.12**	$ 1.49	$ 2.66
Diluted (A/C)	**$ 2.10**	$ 1.48	$ 2.63

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

NOTE 3 — OTHER INCOME (EXPENSE), NET

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

(In millions)

Year Ended June 30,	2016	2015	2014
Dividends and interest income	**$ 903**	$ 766	$ 883
Interest expense	**(1,243)**	(781)	(597)
Net recognized gains on investments	**668**	716	437
Net losses on derivatives	**(443)**	(423)	(328)
Net gains (losses) on foreign currency remeasurements	**(121)**	335	(165)
Other	**(195)**	(267)	(169)
Total	**$ (431)**	$ 346	$ 61

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

(In millions)

Year Ended June 30,	2016	2015	2014
Other-than-temporary impairments of investments	**$ (322)**	$ (183)	$ (106)
Realized gains from sales of available-for-sale securities	**1,376**	1,176	776
Realized losses from sales of available-for-sale securities	**(386)**	(277)	(233)
Total	**$ 668**	$ 716	$ 437

PART II
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NOTE 4 — INVESTMENTS

Investment Components

The components of investments, including associated derivatives, but excluding held-to-maturity investments, were as follows:

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2016							
Cash	**$ 3,501**	**$ 0**	**$ 0**	**$ 3,501**	**$ 3,501**	**$ 0**	**$ 0**
Mutual funds	**1,012**	**0**	**0**	**1,012**	**1,012**	**0**	**0**
Commercial paper	**298**	**0**	**0**	**298**	**298**	**0**	**0**
Certificates of deposit	**1,000**	**0**	**0**	**1,000**	**868**	**132**	**0**
U.S. government and agency securities	**89,970**	**245**	**(11)**	**90,204**	**100**	**90,104**	**0**
Foreign government bonds	**5,502**	**10**	**(18)**	**5,494**	**731**	**4,763**	**0**
Mortgage- and asset-backed securities	**4,789**	**21**	**(2)**	**4,808**	**0**	**4,808**	**0**
Corporate notes and bonds	**6,509**	**110**	**(35)**	**6,584**	**0**	**6,584**	**0**
Municipal securities	**285**	**57**	**0**	**342**	**0**	**342**	**0**
Common and preferred stock	**5,597**	**4,452**	**(236)**	**9,813**	**0**	**0**	**9,813**
Other investments	**590**	**0**	**0**	**590**	**0**	**(3)**	**593**
Total	**$ 119,053**	**$ 4,895**	**$ (302)**	**$ 123,646**	**$ 6,510**	**$ 106,730**	**$ 10,406**

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2015							
Cash	$ 3,679	$ 0	$ 0	$ 3,679	$ 3,679	$ 0	$ 0
Mutual funds	1,100	0	0	1,100	1,100	0	0
Commercial paper	1	0	0	1	1	0	0
Certificates of deposit	906	0	0	906	776	130	0
U.S. government and agency securities	72,843	76	(30)	72,889	39	72,850	0
Foreign government bonds	5,477	3	(24)	5,456	0	5,456	0
Mortgage- and asset-backed securities	4,899	23	(6)	4,916	0	4,916	0
Corporate notes and bonds	7,192	97	(37)	7,252	0	7,252	0
Municipal securities	285	35	(1)	319	0	319	0
Common and preferred stock	6,668	4,986	(215)	11,439	0	0	11,439
Other investments	597	0	0	597	0	8	589
Total	$ 103,647	$ 5,220	$ (313)	$ 108,554	$ 5,595	$ 90,931	$ 12,028

As of June 30, 2016 and 2015, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $767 million and $561 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

As of June 30, 2016 and 2015, the collateral received under agreements for loaned securities totaled $294 million and $92 million, which is primarily comprised of U.S. government and agency securities.

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:

(In millions)	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2016						
U.S. government and agency securities	**$ 5,816**	**$ (3)**	**$ 432**	**$ (8)**	**$ 6,248**	**$ (11)**
Foreign government bonds	**3,452**	**(3)**	**35**	**(15)**	**3,487**	**(18)**
Mortgage- and asset-backed securities	**844**	**(1)**	**322**	**(1)**	**1,166**	**(2)**
Corporate notes and bonds	**1,180**	**(11)**	**788**	**(24)**	**1,968**	**(35)**
Common and preferred stock	**896**	**(147)**	**390**	**(89)**	**1,286**	**(236)**
Total	**$ 12,188**	**$ (165)**	**$ 1,967**	**$ (137)**	**$ 14,155**	**$ (302)**

(In millions)	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2015						
U.S. government and agency securities	$ 6,636	$ (9)	$ 421	$ (21)	$ 7,057	$ (30)
Foreign government bonds	4,611	(12)	18	(12)	4,629	(24)
Mortgage- and asset-backed securities	3,171	(5)	28	(1)	3,199	(6)
Corporate notes and bonds	2,946	(29)	104	(8)	3,050	(37)
Municipal securities	36	(1)	0	0	36	(1)
Common and preferred stock	1,389	(180)	148	(35)	1,537	(215)
Total	$ 18,789	$ (236)	$ 719	$ (77)	$ 19,508	$ (313)

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.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
June 30, 2016		
Due in one year or less	$ 54,503	$ 54,544
Due after one year through five years	50,683	50,896
Due after five years through 10 years	1,914	1,954
Due after 10 years	1,253	1,336
Total	$ 108,353	$ 108,730

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. dollar 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, Canadian dollar, and Australian dollar. As of June 30, 2016 and June 30, 2015, the total notional amounts of these foreign exchange contracts sold were $8.4 billion and $9.8 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, 2016 and June 30, 2015, the total notional amounts of these foreign exchange contracts sold were $5.3 billion for both periods.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in foreign exchange rates on certain balance sheet amounts and to manage other foreign currency exposures. As of June 30, 2016, the total notional amounts of these foreign exchange contracts purchased and sold were $12.0 billion and $11.7 billion, respectively. As of June 30, 2015, the total notional amounts of these foreign exchange contracts purchased and sold were $9.7 billion and $11.0 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, 2016, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.3 billion and $2.2 billion, respectively, of which $737 million and $986 million, respectively, were designated as hedging instruments. As of June 30, 2015, the total notional amounts of equity contracts purchased and sold for managing market price risk were $2.2 billion and $2.6 billion, respectively, of which $1.1 billion and $1.4 billion, respectively, were designated as hedging instruments.

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, 2016, the total notional amounts of fixed-interest rate contracts purchased and sold were $328 million and $2.4 billion, respectively. As of June 30, 2015, the total notional amounts of fixed-interest rate contracts purchased and sold were $1.0 billion and $3.2 billion, respectively.

In addition, we use “To Be Announced” forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of June 30, 2016 and 2015, the total notional derivative amounts of mortgage contracts purchased were $548 million and $812 million, respectively.

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low-cost method of managing exposure to individual credit risks or groups of credit risks. As of June 30, 2016, the total notional amounts of credit contracts purchased and sold were $440 million and $273 million, respectively. As of June 30, 2015, the total notional amounts of credit contracts purchased and sold were $618 million and $430 million, respectively.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swaps, 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, 2016, the total notional amounts of commodity contracts purchased and sold were $631 million and $162 million, respectively. As of June 30, 2015, the total notional amounts of commodity contracts purchased and sold were $882 million and $316 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 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, 2016, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral was required to be posted.

Fair Values of Derivative Instruments

The following table presents the fair values of derivative instruments designated as hedging instruments ("designated hedge derivatives") and not designated as hedging instruments ("non-designated hedge derivatives"). The fair values exclude the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

	June 30, 2016				June 30, 2015			
	Assets			Liabilities	Assets			Liabilities
(In millions)	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities	Short-term Investments	Other Current Assets	Equity and Other Investments	Other Current Liabilities
Non-designated Hedge Derivatives								
Foreign exchange contracts	**$ 33**	**$ 156**	**$ 0**	**$ (296)**	$ 17	$ 167	$ 0	$ (79)
Equity contracts	**23**	**0**	**0**	**(16)**	148	0	0	(18)
Interest rate contracts	**10**	**0**	**0**	**(25)**	7	0	0	(12)
Credit contracts	**6**	**0**	**0**	**(5)**	16	0	0	(9)
Commodity contracts	**0**	**0**	**0**	**0**	0	0	0	0
Total	**$ 72**	**$ 156**	**$ 0**	**$ (342)**	$ 188	$ 167	$ 0	$ (118)
Designated Hedge Derivatives								
Foreign exchange contracts	**$ 1**	**$ 392**	**$ 0**	**$ (263)**	$ 56	$ 552	$ 0	$ (31)
Equity contracts	**0**	**0**	**18**	**(25)**	0	0	25	(69)
Total	**$ 1**	**$ 392**	**$ 18**	**$ (288)**	$ 56	$ 552	$ 25	$ (100)
Total gross amounts of derivatives	**$ 73**	**$ 548**	**$ 18**	**$ (630)**	$ 244	$ 719	$ 25	$ (218)
Gross derivatives either offset or subject to an enforceable master netting agreement	**$ 69**	**$ 548**	**$ 18**	**$ (630)**	$ 126	$ 719	$ 25	$ (218)
Gross amounts of derivatives offset in the balance sheet	**(74)**	**(302)**	**(25)**	**398**	(66)	(71)	(25)	161
Net amounts presented in the balance sheet	**(5)**	**246**	**(7)**	**(232)**	60	648	0	(57)
Gross amounts of derivatives not offset in the balance sheet	**0**	**0**	**0**	**0**	0	0	0	0
Cash collateral received	**0**	**0**	**0**	**(250)**	0	0	0	(456)
Net amount	**$ (5)**	**$ 246**	**$ (7)**	**$ (482)**	$ 60	$ 648	$ 0	$ (513)

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

Fair Value Hedge Gains (Losses)

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

(In millions)

Year Ended June 30,	2016	2015	2014
Foreign Exchange Contracts			
Derivatives	**$ (797)**	$ 741	$ (14)
Hedged items	**838**	(725)	6
Total amount of ineffectiveness	**$ 41**	$ 16	$ (8)
Equity Contracts			
Derivatives	**$ (76)**	$ (107)	$ (110)
Hedged items	**76**	107	110
Total amount of ineffectiveness	**$ 0**	$ 0	$ 0
Amount of equity contracts excluded from effectiveness assessment	**$ (10)**	$ 0	$ (9)

Cash Flow Hedge Gains (Losses)

We recognized the following gains (losses) on foreign exchange contracts designated as cash flow hedges:

(In millions)

Year Ended June 30,	2016	2015	2014
Effective Portion			
Gains recognized in OCI (net of tax effects of **$24**, $35 and $2)	**$ 351**	$ 1,152	$ 63
Gains reclassified from AOCI into revenue	**$ 625**	$ 608	$ 104
Amount Excluded from Effectiveness Assessment and Ineffective Portion			
Losses recognized in other income (expense), net	**$ (354)**	$ (346)	$ (239)

We estimate that $319 million of net derivative gains included in AOCI as of June 30, 2016 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during fiscal year 2016.

Non-Designated Derivative Gains (Losses)

Gains (losses) from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense), net. 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), net, which were immaterial for the periods presented. 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 and gains (losses) from foreign exchange rate changes on certain balance sheet amounts.

(In millions)

Year Ended June 30,	2016	2015	2014
Foreign exchange contracts	**$ (55)**	$ (483)	$ (78)
Equity contracts	**(21)**	(19)	(64)
Interest-rate contracts	**10**	23	24
Credit contracts	**(1)**	(1)	13
Commodity contracts	**(87)**	(223)	71

Total	**$ (154)**	$ (703)	$ (34)

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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, 2016						
Assets						
Mutual funds	**$ 1,012**	**$ 0**	**$ 0**	**$ 1,012**	**$ 0**	**$ 1,012**
Commercial paper	**0**	**298**	**0**	**298**	**0**	**298**
Certificates of deposit	**0**	**1,000**	**0**	**1,000**	**0**	**1,000**
U.S. government and agency securities	**86,492**	**3,707**	**0**	**90,199**	**0**	**90,199**
Foreign government bonds	**10**	**5,705**	**0**	**5,715**	**0**	**5,715**
Mortgage- and asset-backed securities	**0**	**4,803**	**0**	**4,803**	**0**	**4,803**
Corporate notes and bonds	**0**	**6,361**	**1**	**6,362**	**0**	**6,362**
Municipal securities	**0**	**342**	**0**	**342**	**0**	**342**
Common and preferred stock	**6,918**	**2,114**	**18**	**9,050**	**0**	**9,050**
Derivatives	**6**	**633**	**0**	**639**	**(401)**	**238**
Total	**$ 94,438**	**$ 24,963**	**$ 19**	**$ 119,420**	**$ (401)**	**$ 119,019**
Liabilities						
Derivatives and other	**$ 17**	**$ 613**	**$ 0**	**$ 630**	**$ (398)**	**$ 232**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2015						
Assets						
Mutual funds	$ 1,100	$ 0	$ 0	$ 1,100	$ 0	$ 1,100
Commercial paper	0	1	0	1	0	1
Certificates of deposit	0	906	0	906	0	906
U.S. government and agency securities	71,930	955	0	72,885	0	72,885
Foreign government bonds	131	5,299	0	5,430	0	5,430
Mortgage- and asset-backed securities	0	4,917	0	4,917	0	4,917
Corporate notes and bonds	0	7,108	1	7,109	0	7,109
Municipal securities	0	319	0	319	0	319
Common and preferred stock	8,585	2,277	14	10,876	0	10,876
Derivatives	4	979	5	988	(162)	826
Total	$ 81,750	$ 22,761	$ 20	$ 104,531	$ (162)	$ 104,369
Liabilities						
Derivatives and other	$ 5	$ 159	$ 54	$ 218	$ (161)	$ 57

(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 changes in our Level 3 financial instruments that are measured at fair value on a recurring basis were immaterial during the periods presented.

The following table reconciles the total "Net Fair Value" of assets above to our balance sheet presentation of these same assets in Note 4 – Investments.

(In millions)

June 30,	2016	2015
Net fair value of assets measured at fair value on a recurring basis	**$ 119,019**	$ 104,369
Cash	**3,501**	3,679
Common and preferred stock measured at fair value on a nonrecurring basis	**767**	561
Other investments measured at fair value on a nonrecurring basis	**593**	589
Less derivative net assets classified as other current assets	**(246)**	(648)
Other	**12**	4
Recorded basis of investment components	**$ 123,646**	$ 108,554

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

During fiscal year 2016 and 2015, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 — INVENTORIES

The components of inventories were as follows:

(In millions)

June 30,	2016	2015
Raw materials	**$ 612**	$ 1,100
Work in process	**158**	202
Finished goods	**1,481**	1,600
Total	**$ 2,251**	$ 2,902

NOTE 8 — PROPERTY AND EQUIPMENT

The components of property and equipment were as follows:

(In millions)

June 30,	2016	2015
Land	**$ 824**	$ 769
Buildings and improvements	**12,393**	10,800
Leasehold improvements	**3,659**	3,577
Computer equipment and software	**17,391**	13,612
Furniture and equipment	**3,889**	3,579
Total, at cost	**38,156**	32,337
Accumulated depreciation	**(19,800)**	(17,606)
Total, net	**$ 18,356**	$ 14,731

During fiscal years 2016, 2015, and 2014, depreciation expense was $4.9 billion, $4.1 billion, and $3.4 billion, respectively.

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NOTE 9 — BUSINESS COMBINATIONS

Mojang Synergies AB

On November 6, 2014, we acquired Mojang Synergies AB ("Mojang"), the Swedish video game developer of the Minecraft gaming franchise, for $2.5 billion in cash, net of cash acquired. The addition of Minecraft and its community enhances our gaming portfolio across Windows, Xbox, and other ecosystems besides our own. The significant classes of assets and liabilities to which we allocated the purchase price were goodwill of $1.8 billion and identifiable intangible assets of $928 million, primarily marketing-related (trade names). The goodwill recognized in connection with the acquisition is primarily attributable to anticipated synergies from future growth, and is not expected to be deductible for tax purposes. We assigned the goodwill to More Personal Computing under our current segment structure. Identifiable intangible assets were assigned a total weighted-average amortization period of 6.3 years. Mojang has been included in our consolidated results of operations since the acquisition date.

Nokia's Devices and Services Business

On April 25, 2014, we acquired substantially all of Nokia Corporation's ("Nokia") Devices and Services business ("NDS") for a total purchase price of $9.4 billion, including cash acquired of $1.5 billion (the "Acquisition"). The purchase price consisted primarily of cash of $7.1 billion and Nokia's repurchase of convertible notes of $2.1 billion, which was a non-cash transaction, and liabilities assumed of $0.2 billion. The Acquisition was expected to accelerate the growth of our Devices business through faster innovation, synergies, and unified branding and marketing.

The allocation of the purchase price to goodwill was completed as of March 31, 2015. The major classes of assets and liabilities to which we allocated the purchase price were as follows:

(In millions)	
Cash	$ 1,506
Accounts receivable [(a)]	754
Inventories	544
Other current assets	936
Property and equipment	981
Intangible assets	4,509
Goodwill [(b)]	5,456
Other	221
Current liabilities	(4,575)
Long-term liabilities	(890)
Total purchase price	$ 9,442

(a) *Gross accounts receivable was $901 million, of which $147 million was expected to be uncollectible.*
(b) *Goodwill was assigned to More Personal Computing under our current segment structure. The goodwill was primarily attributed to increased synergies that were expected to be achieved from the integration of NDS.*

Following are the details of the purchase price allocated to the intangible assets acquired:

(In millions)	Amount	Weighted Average Life
Technology-based	$ 2,493	9 years
Contract-based	1,500	9 years
Customer-related	359	3 years
Marketing-related (trade names)	157	2 years
Fair value of intangible assets acquired	$ 4,509	8 years

During the fourth quarter of fiscal year 2016, we recorded $630 million of intangible and fixed asset impairment charges, and during the fourth quarter of fiscal year 2015, we recorded $7.5 billion of goodwill and asset impairment charges. The impairment charges for both periods related to our phone business. These costs are included in impairment, integration, and restructuring expenses on our consolidated income statement. See Note 10 – Goodwill and Note 11 – Intangible Assets for additional details.

In May 2016, we announced an agreement to sell our entry-level feature phone assets for $350 million. The transaction is expected to close in the second half of calendar year 2016, subject to regulatory approvals and other closing conditions.

Our consolidated income statement for fiscal year 2014 included revenue and operating loss of $2.0 billion and $692 million, respectively, attributable to NDS since the Acquisition.

Following are the supplemental consolidated results of Microsoft Corporation on an unaudited pro forma basis, as if the Acquisition had been consummated on July 1, 2012:

(In millions, except per share amounts)

Year Ended June 30,	**2014**
Revenue	$ 96,248
Net income	$ 20,234
Diluted earnings per share	$ 2.41

These pro forma results were based on estimates and assumptions, which we believe are reasonable. They are not the results that would have been realized had we been a combined company during the periods presented and are not necessarily indicative of our consolidated results of operations in future periods. The pro forma results include adjustments primarily related to purchase accounting adjustments and the elimination of related party transactions between Microsoft and NDS. Acquisition costs and other nonrecurring charges incurred are included in the earliest period presented.

During the fourth quarter of fiscal year 2014, we incurred $21 million of acquisition costs associated with the purchase of NDS. Acquisition costs are primarily comprised of transaction fees and direct acquisition costs, including legal, finance, consulting, and other professional fees. These costs are included in impairment, integration, and restructuring expenses on our consolidated income statement for fiscal year 2014.

Certain concurrent transactions were recognized separately from the Acquisition. Prior to the Acquisition, we had joint strategic initiatives with Nokia; this contractual relationship was terminated in conjunction with the Acquisition. No gain or loss was recorded upon termination of this agreement, as it was determined to be at market value. In addition, we agreed to license Nokia's mapping services and will pay Nokia separately for the services provided under a four-year license as they are rendered.

Other

During fiscal year 2016, we completed 17 acquisitions for total cash consideration of $1.4 billion. These entities have been included in our consolidated results of operations since their respective acquisition dates.

Pro forma results of operations for Mojang and our other acquisitions during the current period have not been presented because the effects of these business combinations, individually and in aggregate, were not material to our consolidated results of operations.

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NOTE 10 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	June 30, 2014	Acquisitions	Other	June 30, 2015	Acquisitions	Other	June 30, 2016
Productivity and Business Processes	$ 6,116	$ 376	$ (183)	$ 6,309	**$ 443**	**$ (74)**	**$ 6,678**
Intelligent Cloud	4,631	291	(5)	4,917	**549**	**1**	**5,467**
More Personal Computing	9,380	1,788	(5,455)	5,713	**100**	**(86)**	**5,727**
Total goodwill	$ 20,127	$ 2,455	$ (5,643)	$ 16,939	**$ 1,092**	**$ (159)**	**$ 17,872**

The measurement periods for the valuation of assets acquired and liabilities assumed end as soon as information on the facts and circumstances that existed as of the acquisition dates becomes available, but do not exceed 12 months. Adjustments in purchase price allocations may require a recasting of the amounts allocated to goodwill retroactive to the periods in which the acquisitions occurred.

Any change in the goodwill amounts resulting from foreign currency translations and purchase accounting adjustments are presented as “Other” in the above table. Also included in “Other” are business dispositions and transfers between business segments due to reorganizations, as applicable. For fiscal year 2015, a $5.1 billion goodwill impairment charge was included in “Other,” as discussed below. This goodwill impairment charge was included in impairment, integration, and restructuring expenses on our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment in Note 21 – Segment Information and Geographic Data.

Our accumulated goodwill impairment as of both June 30, 2016 and 2015 was $11.3 billion.

As discussed in Note 21 – Segment Information and Geographic Data, during the first quarter of fiscal year 2016 our chief operating decision maker requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. This resulted in a change in our operating segments and reporting units. We allocated goodwill to our new reporting units using a relative fair value approach. In addition, we completed an assessment of any potential goodwill impairment for all reporting units immediately prior to the reallocation and determined that no impairment existed.

Goodwill Impairment

We test goodwill for impairment annually on May 1 at the reporting unit level, primarily using a discounted cash flow methodology with a peer-based, risk-adjusted weighted average cost of capital. We believe use of a discounted cash flow approach is the most reliable indicator of the fair values of the businesses.

No instances of impairment were identified in our May 1, 2016 test.

Upon completion of the annual testing as of May 1, 2015, our previous Phone Hardware reporting unit goodwill was determined to be impaired. Phone Hardware goodwill is included in the Devices reporting unit within More Personal Computing under our current segment structure. In the second half of fiscal year 2015, Phone Hardware did not meet its sales volume and revenue goals, and the mix of units sold had lower margins than planned. These results, along with changes in the competitive marketplace and an evaluation of business priorities, led to a shift in strategic direction and reduced future revenue and profitability expectations for the business. As a result of these changes in strategy and expectations, we forecasted reductions in unit volume growth rates and lower future cash flows used to estimate the fair value of the Phone Hardware reporting unit, which resulted in the determination that an impairment adjustment was required.

Because our annual test indicated that Phone Hardware’s carrying value exceeded its estimated fair value, a second phase of the goodwill impairment test (“Step 2”) was performed specific to Phone Hardware. Under Step 2, the fair value of all Phone Hardware assets and liabilities were estimated, including tangible assets, existing technology, patent agreements, and contractual arrangements, for the purpose of deriving an estimate of the implied fair value of goodwill. The implied fair value of the goodwill was then compared to the recorded goodwill to determine the amount of the impairment. Assumptions used in measuring the value of these assets and liabilities included the discount rates and royalty rates used in valuing the intangible assets, and consideration of the market environment in valuing the tangible assets.

No other instances of impairment were identified in our May 1, 2015 test.

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
June 30,			**2016**			**2015**
Technology-based [(a)]	**$ 5,970**	**$ (3,648)**	**$ 2,322**	$ 5,926	$ (3,149)	$ 2,777
Marketing-related	**1,869**	**(616)**	**1,253**	1,942	(508)	1,434
Contract-based	**796**	**(718)**	**78**	1,192	(710)	482
Customer-related	**465**	**(385)**	**80**	492	(350)	142
Total	**$ 9,100**	**$ (5,367)**	**$ 3,733**	$ 9,552	$ (4,717)	$ 4,835

(a) *Technology-based intangible assets included $115 million and $116 million as of June 30, 2016 and 2015, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

In the third quarter of fiscal year 2016, we corrected our intangible assets in the table above for a $585 million misstatement between gross carrying amount and accumulated amortization as of June 30, 2015. We do not consider this correction to be material, and there was no impact to our consolidated financial statements.

During fiscal year 2016, we recorded impairment charges of $480 million related to intangible assets in the Devices reporting unit within our More Personal Computing segment. In the fourth quarter of fiscal year 2016, we tested these intangible assets for recoverability due to changes in facts and circumstances associated with the shift in strategic direction and reduced profitability expectations for our phone business. Based on the results of our testing, we determined that the carrying value of the intangible assets was not recoverable, and an impairment charge was recorded to the extent that estimated fair value exceeded carrying value. We primarily used the income approach to determine the fair value of the intangible assets and determine the amount of impairment.

During fiscal year 2015, we recorded impairment charges of $2.2 billion related to intangible assets in our previous Phone Hardware reporting unit. Phone Hardware intangible assets are included in the Devices reporting unit under our current segment structure. In the fourth quarter of fiscal year 2015, we tested these intangible assets for recoverability due to changes in facts and circumstances associated with the shift in strategic direction and reduced profitability expectations for Phone Hardware. Based on the results of our testing, we determined that the carrying value of the intangible assets was not recoverable, and an impairment charge was recorded to the extent that estimated fair value exceeded carrying value. We primarily used a relief from royalty income approach to determine the fair value of the intangible assets and determine the amount of impairment.

These intangible assets impairment charges were included in impairment, integration, and restructuring expenses on our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment in Note 21 – Segment Information and Geographic Data.

We estimate that we have no significant residual value related to our intangible assets.

The components of intangible assets acquired during the periods presented were as follows:

(In millions)	Amount	Weighted Average Life	Amount	Weighted Average Life
Year Ended June 30,	2016		2015	
Technology-based	$ 361	4 years	$ 874	5 years
Marketing-related	2	1 year	543	8 years
Customer-related	30	3 years	37	4 years
Total	$ 393	4 years	$ 1,454	6 years

Intangible assets amortization expense was $978 million, $1.3 billion, and $845 million for fiscal years 2016, 2015, and 2014, respectively. Amortization of capitalized software was $69 million, $79 million, and $200 million for fiscal years 2016, 2015, and 2014, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held as of June 30, 2016:

(In millions)	
Year Ending June 30,	
2017	$ 787
2018	677
2019	526
2020	448
2021	379
Thereafter	916
Total	$ 3,733

NOTE 12 — DEBT

Short-term Debt

As of June 30, 2016, we had $12.9 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.43% and maturities ranging from 1 day to 99 days. As of June 30, 2015, we had $5.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.11% and maturities ranging from 8 days to 63 days. The estimated fair value of this commercial paper approximates its carrying value.

We have two $5.0 billion credit facilities that expire on November 1, 2016 and November 14, 2018, respectively. These credit facilities serve as a back-up for our commercial paper program. As of June 30, 2016, we were in compliance with the only financial covenant in both credit agreements, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreements. No amounts were drawn against these credit facilities during any of the periods presented.

Long-term Debt

As of June 30, 2016, the total carrying value and estimated fair value of our long-term debt were $40.8 billion and $44.0 billion, respectively. This is compared to a carrying value and estimated fair value of our long-term debt, including the current portion, of $30.3 billion and $30.5 billion, respectively, as of June 30, 2015. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt, including the current portion, and the associated interest rates were as follows as of June 30, 2016 and 2015:

Due Date	Face Value June 30, 2016	Face Value June 30, 2015	Stated Interest Rate	Effective Interest Rate
	(In millions)			
Notes				
September 25, 2015	**$ ***	$ 1,750	**1.625%**	**1.795%**
February 8, 2016	*****	750	**2.500%**	**2.642%**
November 15, 2017	**600**	600	**0.875%**	**1.084%**
May 1, 2018	**450**	450	**1.000%**	**1.106%**
November 3, 2018 (a)	**1,750**	*	**1.300%**	**1.396%**
December 6, 2018	**1,250**	1,250	**1.625%**	**1.824%**
June 1, 2019	**1,000**	1,000	**4.200%**	**4.379%**
February 12, 2020	**1,500**	1,500	**1.850%**	**1.935%**
October 1, 2020	**1,000**	1,000	**3.000%**	**3.137%**
November 3, 2020 (a)	**2,250**	*	**2.000%**	**2.093%**
February 8, 2021	**500**	500	**4.000%**	**4.082%**
December 6, 2021 (b)	**1,944**	1,950	**2.125%**	**2.233%**
February 12, 2022	**1,500**	1,500	**2.375%**	**2.466%**
November 3, 2022 (a)	**1,000**	*	**2.650%**	**2.717%**
November 15, 2022	**750**	750	**2.125%**	**2.239%**
May 1, 2023	**1,000**	1,000	**2.375%**	**2.465%**
December 15, 2023	**1,500**	1,500	**3.625%**	**3.726%**
February 12, 2025	**2,250**	2,250	**2.700%**	**2.772%**
November 3, 2025 (a)	**3,000**	*	**3.125%**	**3.176%**
December 6, 2028 (b)	**1,944**	1,950	**3.125%**	**3.218%**
May 2, 2033 (b)	**611**	613	**2.625%**	**2.690%**
February 12, 2035	**1,500**	1,500	**3.500%**	**3.604%**
November 3, 2035 (a)	**1,000**	*	**4.200%**	**4.260%**
June 1, 2039	**750**	750	**5.200%**	**5.240%**
October 1, 2040	**1,000**	1,000	**4.500%**	**4.567%**
February 8, 2041	**1,000**	1,000	**5.300%**	**5.361%**
November 15, 2042	**900**	900	**3.500%**	**3.571%**
May 1, 2043	**500**	500	**3.750%**	**3.829%**
December 15, 2043	**500**	500	**4.875%**	**4.918%**
February 12, 2045	**1,750**	1,750	**3.750%**	**3.800%**
November 3, 2045 (a)	**3,000**	*	**4.450%**	**4.492%**
February 12, 2055	**2,250**	2,250	**4.000%**	**4.063%**
November 3, 2055 (a)	**1,000**	*	**4.750%**	**4.782%**
Total	**$ 40,949**	$ 30,463		

(a) *In November 2015, we issued $13.0 billion of debt securities.*
(b) *Euro-denominated debt securities.*
* *Not applicable*

The notes in the table above are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. Cash paid for interest on our debt for fiscal years 2016, 2015, and 2014 was $1.1 billion, $620 million, and $509 million, respectively. As of June 30, 2016 and 2015, the aggregate unamortized discount for our long-term debt, including the current portion, was $166 million and $156 million, respectively.

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Maturities of our long-term debt for each of the next five years and thereafter are as follows:

(In millions)

Year Ending June 30,	
2017	$ 0
2018	1,050
2019	4,000
2020	1,500
2021	3,750
Thereafter	30,649
Total	$ 40,949

NOTE 13 — INCOME TAXES

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

(In millions)

Year Ended June 30,	**2016**	**2015**	**2014**
Current Taxes			
U.S. federal	**$ 545**	$ 3,661	$ 3,738
U.S. state and local	**136**	364	266
Foreign	**1,940**	2,065	2,073
Current taxes	**2,621**	6,090	6,077
Deferred Taxes			
Deferred taxes	**332**	224	(331)
Provision for income taxes	**$ 2,953**	$ 6,314	$ 5,746

U.S. and foreign components of income (loss) before income taxes were as follows:

(In millions)

Year Ended June 30,	**2016**	**2015**	**2014**
U.S.	**$ (325)**	$ 7,363	$ 7,127
Foreign	**20,076**	11,144	20,693
Income before income taxes	**$ 19,751**	$ 18,507	$ 27,820

In fiscal year 2016, income before income taxes included the net impact of U.S. and foreign revenue deferrals related to the sales of Windows 10 of $6.0 billion and $588 million, respectively. In fiscal year 2015, income before income taxes included the net impact of U.S. and foreign impairment, integration, and restructuring expenses relating to our phone business of $1.1 billion and $8.9 billion, respectively.

The items accounting for the difference between income taxes computed at the U.S. federal statutory rate and our effective rate were as follows:

Year Ended June 30,	**2016**	**2015**	**2014**
Federal statutory rate	**35.0%**	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	**(19.4)%**	(20.9)%	(17.1)%
Phone nondeductible charges and valuation allowance	**1.3%**	19.1%	0.9%
Domestic production activities deduction	**(0.6)%**	(2.4)%	(1.0)%

Excess tax benefits relating to stock-based compensation	**(2.0)%**	0%	0%
Other reconciling items, net	**0.7%**	3.3%	2.9%
Effective rate	**15.0%**	34.1%	20.7%

The reduction from the federal statutory rate is primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico. Our foreign regional operating centers, which are taxed at rates lower than the U.S. rate, generated 69%, 73%, and 81% of our foreign income before tax in fiscal years 2016, 2015, and 2014, respectively. In general, other reconciling items consist of interest, U.S. state income taxes, and credits. In fiscal years 2016, 2015, and 2014, there were no individually significant other reconciling items.

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

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

(In millions)

June 30,	**2016**	**2015**
Deferred Income Tax Assets		
Stock-based compensation expense	**$ 809**	$ 884
Other expense items	**1,609**	1,531
Restructuring charges	**284**	211
Unearned revenue	**494**	520
Impaired investments	**226**	257
Loss carryforwards	**1,703**	1,158
Depreciation and amortization	**115**	798
Other revenue items	**89**	56
Deferred income tax assets	**5,329**	5,415
Less valuation allowance	**(2,180)**	(2,265)
Deferred income tax assets, net of valuation allowance	**$ 3,149**	$ 3,150
Deferred Income Tax Liabilities		
Foreign earnings	**$ (1,242)**	$ (1,280)
Unrealized gain on investments and debt	**(2,102)**	(2,223)
Depreciation and amortization	**(1,008)**	(685)
Other	**(54)**	(29)
Deferred income tax liabilities	**(4,406)**	(4,217)
Net deferred income tax assets (liabilities)	**$ (1,257)**	$ (1,067)
Reported As		
Other long-term assets [a]	**$ 219**	$ 228
Long-term deferred income tax liabilities [a]	**(1,476)**	(1,295)
Net deferred income tax assets (liabilities) [a]	**$ (1,257)**	$ (1,067)

(a) *Balances as of June 30, 2015 reflect the impact of the adoption of the new accounting standard in fiscal year 2016 related to balance sheet classification of deferred taxes. See Note 1 – Accounting Policies for additional details.*

As of June 30, 2016, we had net operating loss carryforwards of $8.0 billion, including $6.3 billion of foreign net operating loss carryforwards. The valuation allowance disclosed in the table above relates to the foreign net operating loss carryforwards and other net deferred tax assets that may not be realized.

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.

As of June 30, 2016, we have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $124.0 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 was approximately $39.3 billion as of June 30, 2016.

Income taxes paid were $3.9 billion, $4.4 billion, and $5.5 billion in fiscal years 2016, 2015, and 2014, respectively.

Tax contingencies and other income tax liabilities were $11.8 billion and $12.1 billion as of June 30, 2016 and 2015, respectively, and are included in other long-term liabilities. This decrease relates primarily to tax credits available for carryover and a partial settlement of the IRS audit for tax years 2007 to 2009, offset by increases relating to intercompany transfer pricing.

Uncertain Tax Positions

Unrecognized tax benefits as of June 30, 2016, 2015, and 2014, were $10.2 billion, $9.6 billion, and $8.7 billion, respectively. If recognized, these tax benefits would affect our effective tax rates for fiscal years 2016, 2015, and 2014, by $8.8 billion, $7.9 billion, and $7.0 billion, respectively.

As of June 30, 2016, 2015, and 2014, we had accrued interest expense related to uncertain tax positions of $1.9 billion, $1.7 billion, and $1.5 billion, respectively, net of federal income tax benefits. Interest expense on unrecognized tax benefits was $163 million, $237 million, and $235 million in fiscal years 2016, 2015, and 2014, respectively, and was included in provision for income taxes.

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

(In millions)

Year Ended June 30,	**2016**	**2015**	**2014**
Balance, beginning of year	**$ 9,599**	$ 8,714	$ 8,648
Decreases related to settlements	**(201)**	(50)	(583)
Increases for tax positions related to the current year	**1,086**	1,091	566
Increases for tax positions related to prior years	**115**	94	217
Decreases for tax positions related to prior years	**(317)**	(144)	(95)
Decreases due to lapsed statutes of limitations	**(118)**	(106)	(39)
Balance, end of year	**$ 10,164**	$ 9,599	$ 8,714

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

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2016, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

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NOTE 14 — RESTRUCTURING CHARGES

Phone Hardware Integration

In July 2014, we announced a restructuring plan to simplify our organization and align NDS with our company's overall strategy (the "Phone Hardware Integration Plan"). Pursuant to the Phone Hardware Integration Plan, we eliminated approximately 19,000 positions in fiscal year 2015, including approximately 13,000 professional and factory positions related to the NDS business. The actions associated with the Phone Hardware Integration Plan were completed as of June 30, 2015.

In connection with the Phone Hardware Integration Plan, we incurred total restructuring charges of $1.3 billion, including severance expenses and other reorganization costs, primarily associated with our facilities consolidation and write-downs of certain assets. All restructuring charges incurred under the Phone Hardware Integration Plan were recognized in fiscal year 2015.

Phone Hardware Restructuring

In June 2015, management approved a plan to restructure our phone business to better focus and align resources (the "Phone Hardware Restructuring Plan"), under which we eliminated approximately 7,400 positions in fiscal year 2016.

In fiscal year 2015, we incurred restructuring charges of $780 million under the Phone Hardware Restructuring Plan, including severance expenses and other reorganization costs. In fiscal year 2016, we reversed $21 million of previously estimated restructuring charges related to contract termination costs. The actions associated with the Phone Hardware Restructuring Plan were substantially complete as of June 30, 2016, and are expected to be completed by the end of calendar year 2016.

2016 Restructuring

We periodically evaluate how to best deploy the company's resources. In the fourth quarter of 2016, management approved restructuring plans that would result in job eliminations, primarily across our smartphone hardware business and global sales. In addition to the elimination of 1,850 positions that were announced in May 2016, approximately 2,850 roles globally will be reduced during the year as an extension of the earlier plan, and these actions are expected to be completed by the end of fiscal year 2017.

In connection with the restructuring plans, we incurred restructuring charges of $501 million in fiscal year 2016, including severance expenses and other reorganization costs. We do not expect to incur additional charges for these restructuring plans in subsequent years.

Restructuring charges associated with each of these plans were included in impairment, integration, and restructuring expenses on our consolidated income statement, and reflected in Corporate and Other in our table of operating income (loss) by segment in Note 21– Segment Information and Geographic Data.

Changes in the restructuring liability were as follows:

(In millions)	Severance	Other [(a)]	Total
Restructuring liability as of June 30, 2015	$ 588	$ 249	$ 837
Restructuring charges	372	129	501
Reversal of prior year restructuring charges	0	(21)	(21)
Cash paid	(466)	(112)	(578)
Other	(24)	(6)	(30)
Restructuring liability as of June 30, 2016	$ 470	$ 239	$ 709

(a) "*Other*" *primarily reflects activities associated with the consolidation of our facilities and manufacturing operations, including contract termination costs and asset write-downs.*

NOTE 15 — UNEARNED REVENUE

Unearned revenue by segment was as follows:

(In millions)

June 30,	**2016**	**2015**
Productivity and Business Processes	**$ 12,482**	$ 11,643
Intelligent Cloud	**11,472**	10,346
More Personal Computing	**3,246**	3,246
Corporate and Other	**6,709**	83
Total	**$ 33,909**	$ 25,318

Revenue from Windows 10 is primarily recognized at the time of billing in the More Personal Computing segment, and the deferral and subsequent recognition of revenue is reflected in Corporate and Other in the table above. As of June 30, 2016, we deferred a net $6.6 billion in revenue related to Windows 10.

NOTE 16 — COMMITMENTS

Construction and Operating Lease Commitments

We have committed $2.0 billion for constructing new buildings, building improvements, and leasehold improvements as of June 30, 2016.

We have operating leases for most U.S. and international sales and support offices, research and development facilities, manufacturing facilities, retail stores, and certain equipment. Rental expense for facilities operating leases was $1.0 billion, $989 million, and $874 million, in fiscal years 2016, 2015, and 2014, respectively. Future minimum rental commitments under non-cancellable facilities operating leases in place as of June 30, 2016 are as follows:

(In millions)

Year Ending June 30,	
2017	$ 961
2018	996
2019	922
2020	833
2021	634
Thereafter	2,118
Total	$ 6,464

Other Commitments

On June 11, 2016, we entered into a definitive agreement to acquire LinkedIn Corporation (“LinkedIn”) for $196 per share in an all-cash transaction valued at $26.2 billion, inclusive of LinkedIn’s net cash (the “Merger Agreement”). We will finance the transaction primarily through the issuance of new indebtedness. The Merger Agreement has been unanimously approved by the Boards of Directors of both Microsoft and LinkedIn, and we expect the acquisition will close in the 2016 calendar year, subject to approval by LinkedIn’s shareholders, satisfaction of certain regulatory approvals, and other customary closing conditions. The transaction is expected to accelerate the growth of LinkedIn, as well as Office 365 and Dynamics.

NOTE 17 — CONTINGENCIES

Patent and Intellectual Property Claims

IPCom patent litigation

IPCom GmbH & Co. ("IPCom") is a German company that holds a large portfolio of mobile technology-related patents spanning about 170 patent families and addressing a broad range of cellular technologies. IPCom has asserted 19 of these patents in litigation against Nokia and many of the leading cell phone companies and operators. In November 2014, Microsoft and IPCom entered into a standstill agreement staying all of the pending litigation against Microsoft to permit the parties to pursue settlement discussions.

InterDigital patent litigation

InterDigital Technology Corporation and InterDigital Communications Corporation (collectively, "IDT") filed four patent infringement cases against Nokia in the International Trade Commission ("ITC") and in U.S. District Court for the District of Delaware between 2007 and 2013. We have been added to these cases as a defendant. IDT has cases pending against other defendants based on the same patents because most of the patents at issue allegedly relate to 3G and 4G wireless communications standards essential functionality. The cases involving us include three ITC investigations where IDT sought an order excluding importation of 3G and 4G phones into the U.S. and one active case in U.S. District Court in Delaware seeking an injunction and damages. Each of the ITC matters has been resolved in our favor. In September 2015, in an *inter partes* review the United States Patent Trial and Appeal Board issued a final written decision that deemed unpatentable all asserted claims of the patent remaining at issue in the Delaware case. IDT has appealed this decision to the U.S. Court of Appeals for the Federal Circuit. The Delaware case has been stayed pending final completion of the *inter partes* review (including appeals and any subsequent proceedings in the Patent Office). We filed an antitrust complaint against IDT in the District of Delaware in August 2015 asserting violations of Section 2 of the Sherman Act, alleging the unlawful exploitation of standard essential patents. IDT filed a motion to dismiss, which the District Court denied.

European copyright levies

We assumed from Nokia all potential liability due to Nokia's alleged failure to pay "private copying levies" in various European countries based upon sale of memory cards and mobile phones that incorporate blank memory. The levies are based upon a 2001 European Union ("EU") Directive establishing a right for end users to make copies of copyrighted works for personal or private use, but also allowing the collection of levies based upon sales of blank media or recording devices to compensate copyright holders for private copying. Various collecting societies in EU countries initiated litigation against Nokia, stating that Nokia must pay levies not only based upon sales of blank memory cards, but also phones that include blank memory for data storage on the phones, regardless of actual usage of that memory. The most significant cases against Nokia are pending in Germany and Austria, due to both the high volume of sales and high levy amounts sought in these countries. In December 2015, the industry group BITKOM, of which we are a member, reached a settlement with the German collecting society for all claims from 2008 forward, leaving litigation only for the period 2004-2007 pending in Germany. In addition, the industry is engaged in settlement negotiations with the Austrian collecting society. We have also settled copyright levies litigation in Spain and France.

Other patent and intellectual property claims

In addition to these cases, there were 54 other patent infringement cases pending against Microsoft as of June 30, 2016.

Antitrust, Unfair Competition, and Overcharge Class Actions

Antitrust and unfair competition class action lawsuits were filed against us in British Columbia, Ontario, and Quebec, Canada. All three have been certified on behalf of Canadian indirect purchasers who acquired licenses for Microsoft operating system software and/or productivity application software between 1998 and 2010.

The trial of the British Columbia action commenced in May 2016. The plaintiffs are expected to file their case in chief in August 2016, setting out claims made, authorities, and evidence in support. A six-month oral hearing is scheduled to commence in September 2017, consisting of cross examination on witness affidavits. The Ontario and Quebec cases are inactive.

Other Antitrust Litigation and Claims

*China State Administration for Industry and Commerce investigatio*n

In 2014, Microsoft was informed that China's State Administration for Industry and Commerce ("SAIC") had begun a formal investigation relating to China's Anti-Monopoly Law, and the SAIC conducted onsite inspections of Microsoft offices in Beijing, Shanghai, Guangzhou, and Chengdu. SAIC has stated the investigation relates to compatibility, bundle sales, file verification issues related to Windows and Office software, and potentially other issues.

Product-Related Litigation

U.S. cell phone litigation

Nokia, along with other handset manufacturers and network operators, is a defendant in 19 lawsuits filed in the Superior Court for the District of Columbia by individual plaintiffs who allege that radio emissions from cellular handsets caused their brain tumors and other adverse health effects. We assumed responsibility for these claims as part of the NDS acquisition and have been substituted for the Nokia defendants. Nine of these cases were filed in 2002 and are consolidated for certain pre-trial proceedings; the remaining 10 cases are stayed. In a separate 2009 decision, the Court of Appeals for the District of Columbia held that adverse health effect claims arising from the use of cellular handsets that operate within the U.S. Federal Communications Commission radio frequency emission guidelines ("FCC Guidelines") are pre-empted by federal law. The plaintiffs allege that their handsets either operated outside the FCC Guidelines or were manufactured before the FCC Guidelines went into effect. The lawsuits also allege an industry-wide conspiracy to manipulate the science and testing around emission guidelines.

In 2013, defendants in the consolidated cases moved to exclude plaintiffs' expert evidence of general causation on the basis of flawed scientific methodologies. In 2014, the court granted in part defendants' motion to exclude plaintiffs' general causation experts. The plaintiffs filed an interlocutory appeal challenging the standard for evaluating expert scientific evidence, which the District of Columbia Court of Appeals agreed to hear *en banc*. Trial court proceedings are stayed pending resolution of the appeal.

Canadian cell phone class action

Nokia, along with other handset manufacturers and network operators, is a defendant in a 2013 class action lawsuit filed in the Supreme Court of British Columbia by a purported class of Canadians who have used cellular phones for at least 1,600 hours, including a subclass of users with brain tumors. Microsoft was served with the complaint in June 2014 and has been substituted for the Nokia defendants. The litigation is not yet active as several defendants remain to be served.

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 consolidated 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, 2016, we accrued aggregate legal liabilities of $521 million in other current liabilities. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $1.6 billion in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our consolidated financial statements for the period in which the effects become reasonably estimable.

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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. Additionally, we have agreed to cover damages resulting from breaches of certain security and privacy commitments in our cloud business. 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 on our consolidated financial statements.

NOTE 18 — STOCKHOLDERS' EQUITY

Shares Outstanding

Shares of common stock outstanding were as follows:

(In millions)

Year Ended June 30,	2016	2015	2014
Balance, beginning of year	**8,027**	8,239	8,328
Issued	**75**	83	86
Repurchased	**(294)**	(295)	(175)
Balance, end of year	**7,808**	8,027	8,239

Share Repurchases

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to $40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. This share repurchase program replaced the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013. As of June 30, 2016, $7.1 billion remained of our $40.0 billion share repurchase program. All repurchases were made using cash resources.

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

(In millions)	Shares	Amount	Shares	Amount	Shares	Amount
Year Ended June 30,		2016		2015		2014 (a)
First quarter	**89**	**$ 4,000**	43	$ 2,000	47	$ 1,500
Second quarter	**66**	**3,600**	43	2,000	53	2,000
Third quarter	**69**	**3,600**	116	5,000	47	1,791
Fourth quarter	**70**	**3,600**	93	4,209	28	1,118
Total	**294**	**$ 14,800**	295	$ 13,209	175	$ 6,409

(a) *Of the 175 million shares repurchased in fiscal year 2014, 128 million shares were repurchased for $4.9 billion under the share repurchase program approved by our Board of Directors on September 16, 2013 and 47 million shares were repurchased for $1.5 billion under the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013.*

The above table excludes shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards.

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Dividends

In fiscal year 2016, our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(In millions)	
September 15, 2015	**$ 0.36**	**November 19, 2015**	**$ 2,868**	**December 10, 2015**
December 2, 2015	**$ 0.36**	**February 18, 2016**	**$ 2,842**	**March 10, 2016**
March 15, 2016	**$ 0.36**	**May 19, 2016**	**$ 2,821**	**June 9, 2016**
June 14, 2016	**$ 0.36**	**August 18, 2016**	**$ 2,811**	**September 8, 2016**

The dividend declared on June 14, 2016 will be paid after the filing date of the 2016 Form 10-K and was included in other current liabilities as of June 30, 2016.

In fiscal year 2015, our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(In millions)	
September 16, 2014	$ 0.31	November 20, 2014	$ 2,547	December 11, 2014
December 3, 2014	$ 0.31	February 19, 2015	$ 2,532	March 12, 2015
March 10, 2015	$ 0.31	May 21, 2015	$ 2,496	June 11, 2015
June 9, 2015	$ 0.31	August 20, 2015	$ 2,475	September 10, 2015

The dividend declared on June 9, 2015 was included in other current liabilities as of June 30, 2015.

NOTE 19 — ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the changes in accumulated other comprehensive income by component:

(In millions)

Year Ended June 30,	2016	2015	2014
Derivatives			
Accumulated other comprehensive income balance, beginning of period	**$ 590**	$ 31	$ 66
Unrealized gains, net of tax effects of **$24**, $35 and $2	**351**	1,152	63
Reclassification adjustments for gains included in revenue	**(625)**	(608)	(104)
Tax expense included in provision for income taxes	**36**	15	6
Amounts reclassified from accumulated other comprehensive income	**(589)**	(593)	(98)
Net current period other comprehensive income (loss)	**(238)**	559	(35)
Accumulated other comprehensive income balance, end of period	**$ 352**	$ 590	$ 31
Investments			
Accumulated other comprehensive income balance, beginning of period	**$ 3,169**	$ 3,531	$ 1,794
Unrealized gains, net of tax effects of **$120**, $59 and $1,067	**219**	110	2,053
Reclassification adjustments for gains included in other income (expense), net	**(688)**	(728)	(447)
Tax expense included in provision for income taxes	**241**	256	131
Amounts reclassified from accumulated other comprehensive income	**(447)**	(472)	(316)
Net current period other comprehensive income (loss)	**(228)**	(362)	1,737
Accumulated other comprehensive income balance, end of period	**$ 2,941**	$ 3,169	$ 3,531

Translation Adjustments and Other			
Accumulated other comprehensive income (loss) balance, beginning of period	**$ (1,237)**	$ 146	$ (117)
Translation adjustments and other, net of tax effects of **$(33)**, $16 and $12	**(519)**	(1,383)	263
Accumulated other comprehensive income (loss) balance, end of period	**$ (1,756)**	$ (1,237)	$ 146
Accumulated other comprehensive income, end of period	**$ 1,537**	$ 2,522	$ 3,708

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NOTE 20 — EMPLOYEE STOCK AND SAVINGS PLANS

We grant stock-based compensation to employees and directors. As of June 30, 2016 an aggregate of 214 million shares were authorized for future grant under our stock plans. Awards that expire or are canceled without delivery of shares generally become available for issuance under the plans. We issue new shares of Microsoft common stock to satisfy exercises and vesting of awards granted under all of our stock plans. We also have an ESPP for all eligible employees.

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

(In millions)

Year Ended June 30,	2016	2015	2014
Stock-based compensation expense	**$ 2,668**	$ 2,574	$ 2,446
Income tax benefits related to stock-based compensation	**882**	868	830

Stock Plans

Stock awards entitle the holder to receive shares of Microsoft common stock as the award vests. Stock awards generally vest over a four or five-year service period.

Executive incentive plan

Under the Executive Incentive Plan, the Compensation Committee approves stock awards to executive officers and certain senior executives. The stock awards vest ratably in August of each of the four years following the grant date.

Activity for all stock plans

The fair value of stock awards were estimated on the date of grant using the following assumptions:

Year Ended June 30,	2016	2015	2014
Dividends per share (quarterly amounts)	**$ 0.31 - $ 0.36**	$ 0.28 - $ 0.31	$ 0.23 - $ 0.28
Interest rates	**1.1% -1.8%**	1.2% - 1.9%	1.3% - 1.8%

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

	Shares	Weighted Average Grant-Date Fair Value
	(In millions)	
Stock Awards		
Nonvested balance, beginning of year	**216**	**$ 32.72**
Granted	**83**	**$ 41.51**
Vested	**(85)**	**$ 30.98**
Forfeited	**(20)**	**$ 35.93**
Nonvested balance, end of year	**194**	**$ 36.92**

As of June 30, 2016, there was approximately $4.8 billion of total unrecognized compensation costs related to stock awards. These costs are expected to be recognized over a weighted average period of 3 years. The weighted average grant-date fair value of stock award granted was $41.51, $42.36, and $31.50 for fiscal years 2016, 2015, and 2014, respectively. The fair value of stock awards vested was $3.9 billion, $4.2 billion, and $3.2 billion, for fiscal years 2016, 2015, and 2014, respectively.

Employee Stock Purchase Plan

We have an ESPP 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 trading 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,	2016	2015	2014
Shares purchased	**15**	16	18
Average price per share	**$ 44.83**	$ 39.87	$ 33.60

As of June 30, 2016, 142 million shares of our common stock were reserved for future issuance through the ESPP.

Savings Plan

We have a savings plan in the U.S. 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 a portion of their salary, subject to certain limitations. Beginning January 2016, we contribute fifty cents for each dollar a participant contributes in this plan, with a maximum employer contribution of 50% of the IRS contribution limit for the calendar year. Prior to January 2016, we contributed fifty cents for each dollar of the first 6% a participant contributed in this plan, with a maximum contribution of the lesser of 3% of a participant’s earnings or 3% of the IRS compensation limit for the calendar year. Matching contributions for all plans were $549 million, $454 million, and $420 million in fiscal years 2016, 2015, and 2014, respectively, and were expensed as contributed.

NOTE 21 — SEGMENT INFORMATION AND GEOGRAPHIC DATA

In its operation of the business, management, including our chief operating decision maker, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP.

In June 2015, we announced a change in organizational structure to align to our strategic direction as a productivity and platform company. During the first quarter of fiscal year 2016, our chief operating decision maker requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. As a result, beginning in fiscal year 2016, we report our financial performance based on our new segments, Productivity and Business Processes, Intelligent Cloud, and More Personal Computing, and analyze operating income as the measure of segment profitability. We have recast certain prior period amounts to conform to the way we internally manage and monitor segment performance.

Our reportable segments are described below.

Productivity and Business Processes

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

- Office Commercial, including volume licensing and subscriptions to Office 365 commercial for products and services such as Office, Exchange, SharePoint, and Skype for Business, and related Client Access Licenses (“CALs”).
- Office Consumer, including Office sold through retail or through an Office 365 consumer subscription, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.
- Dynamics business solutions, including Dynamics ERP products, Dynamics CRM on-premises, and Dynamics CRM Online.

Intelligent Cloud

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

- Server products and cloud services, including Microsoft SQL Server, Windows Server, Visual Studio, System Center, and related CALs, as well as Azure.
- Enterprise Services, including Premier Support Services and Microsoft Consulting Services.

More Personal Computing

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

- Windows, including Windows original equipment manufacturer licensing ("Windows OEM") and other non-volume licensing of the Windows operating system, volume licensing of the Windows operating system, patent licensing, Windows Embedded, MSN display advertising, and Windows Phone licensing.
- Devices, including Surface, phones, and PC accessories.
- Gaming, including Xbox hardware; Xbox Live, comprising transactions, subscriptions, and advertising; video games; and third-party video game royalties.
- Search advertising.

Revenue and costs are generally directly attributed to our segments. However, due to the integrated structure of our business, certain revenue recognized and costs incurred by one segment may benefit other segments. Revenue on certain contracts is allocated among the segments based on the relative value of the underlying products and services, which can include allocation based on actual prices charged, prices when sold separately, or estimated costs plus a profit margin. Cost of revenue is allocated in certain cases based on a relative revenue methodology. Operating expenses that are allocated primarily include those relating to marketing of products and services from which multiple segments benefit, and are generally allocated based on relative gross margin.

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: legal, including settlements, and fines; information technology; human resources; finance; excise taxes; field selling; 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 corporate-level activity is not allocated to our segments, including impairment, integration, and restructuring expenses.

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

(In millions)

Year Ended June 30,	**2016**	**2015**	**2014**
Revenue			
Productivity and Business Processes	**$ 26,487**	$ 26,430	$ 26,976
Intelligent Cloud	**25,042**	23,715	21,735
More Personal Computing	**40,460**	43,160	38,460
Corporate and Other	**(6,669)**	275	(338)
Total revenue	**$ 85,320**	$ 93,580	$ 86,833

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(In millions)

Year Ended June 30,	2016	2015	2014
Operating income (loss)			
Productivity and Business Processes	**$ 12,461**	$ 13,359	$ 14,173
Intelligent Cloud	**9,358**	9,871	8,446
More Personal Computing	**6,142**	4,667	5,605
Corporate and Other	**(7,779)**	(9,736)	(465)
Total operating income	**$ 20,182**	$ 18,161	$ 27,759

Corporate and Other operating income (loss) includes adjustments to conform our internal accounting policies to U.S. GAAP, and impairment, integration, and restructuring expenses. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition.

Corporate and Other operating income (loss) activity was as follows during the periods presented:

(In millions)

Year Ended June 30,	2016	2015	2014
Impairment, integration and restructuring expenses	**$ (1,110)**	$ (10,011)	$ (127)
Revenue reconciling amounts and other [(a)]	**(6,669)**	275	(338)
Total Corporate and Other	**$ (7,779)**	$ (9,736)	$ (465)

(a) *Revenue reconciling amounts and other for fiscal year 2016 primarily consisted of a net $6.6 billion of revenue deferrals related to sales of Windows 10. Revenue reconciling amounts for fiscal year 2015 included a net $303 million of previously deferred net revenue related to sales of bundled products and services ("Bundled Offerings"). Revenue reconciling amounts for fiscal year 2014 included a net $349 million of revenue deferrals related to Bundled Offerings.*

No sales to an individual customer or country other than the United States accounted for more than 10% of fiscal year 2016, 2015, or 2014 revenue. Revenue, classified by the major geographic areas in which our customers are located, was as follows:

(In millions)

Year Ended June 30,	2016	2015	2014
United States [(a)]	**$ 40,578**	$ 42,941	$ 43,474
Other countries	**44,742**	50,639	43,359
Total	**$ 85,320**	$ 93,580	$ 86,833

(a) *Includes billings to OEMs and certain multinational organizations because of the nature of these businesses and the impracticability of determining the geographic source of the revenue.*

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

(In millions)

Year Ended June 30,	2016	2015	2014
Microsoft Office system	**$ 23,588**	$ 23,538	$ 24,323
Server products and tools	**19,177**	18,612	17,055
Xbox	**9,395**	9,121	8,643
Windows PC operating system	**8,104** [(a)]	14,826	16,856
Advertising	**6,098**	4,557	4,016
Consulting and product support services	**5,641**	5,090	4,767
Surface	**4,108**	3,900	1,883

Phone	**3,358**	7,702	3,073
Other	**5,851**	6,234	6,217
Total	**$ 85,320**	$ 93,580	$ 86,833

(a) *Includes a net $6.6 billion of revenue deferrals related to sales of Windows 10.*

Our total commercial cloud revenue, which primarily comprises Office 365 commercial, Azure, Dynamics Online, and other cloud properties, was $9.5 billion, $5.8 billion, and $2.8 billion in fiscal years 2016, 2015, and 2014, respectively. These amounts are included in their respective product categories in the table above.

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; 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.

Long-lived assets, excluding financial instruments and tax assets, classified by the location of the controlling statutory company and with countries over 10% of the total shown separately, were as follows:

(In millions)

June 30,	2016	2015	2014
United States	**$ 22,819**	$ 19,562	$ 17,653
Luxembourg	**6,854**	6,879	6,913
Finland	**389**	1,757	9,840
Other countries	**9,899**	8,307	5,713
Total	**$ 39,961**	$ 36,505	$ 40,119

NOTE 22 — QUARTERLY INFORMATION (UNAUDITED)

(In millions, except per share amounts)

Quarter Ended	September 30	December 31	March 31	June 30	Total
Fiscal Year 2016					
Revenue [a]	**$ 20,379**	**$ 23,796**	**$ 20,531**	**$ 20,614**	**$ 85,320**
Gross margin	**13,172**	**13,924**	**12,809**	**12,635**	**52,540**
Operating income	**5,793**	**6,026**	**5,283**	**3,080**	**20,182**
Net income	**4,902**	**5,018**	**3,756**	**3,122** [b]	**16,798** [b]
Basic earnings per share	**0.61**	**0.63**	**0.48**	**0.40**	**2.12**
Diluted earnings per share	**0.61**	**0.62**	**0.47**	**0.39** [b]	**2.10** [b]
Fiscal Year 2015					
Revenue	$ 23,201	$ 26,470	$ 21,729	$ 22,180	$ 93,580
Gross margin	14,928	16,334	14,568	14,712	60,542
Operating income (loss)	5,844	7,776	6,594	(2,053)	18,161
Net income (loss)	4,540	5,863	4,985	(3,195) [c]	12,193 [d]
Basic earnings (loss) per share	0.55	0.71	0.61	(0.40)	1.49
Diluted earnings (loss) per share	0.54	0.71	0.61	(0.40) [c]	1.48 [d]

(a) *Reflects the impact of the net revenue deferral from Windows 10 of $1.3 billion, $1.7 billion, $1.6 billion, and $2.0 billion, for the first, second, third, and fourth quarter of fiscal year 2016, respectively, and $6.6 billion for fiscal year 2016.*

(b) *Includes $630 million of asset impairment charges related to our phone business, and $480 million of restructuring charges associated with our 2016 restructuring plans, which together decreased net income and diluted EPS by $895 million and $0.11, respectively.*

(c) *Includes $7.5 billion of goodwill and asset impairment charges related to our phone business, and $940 million of integration and restructuring expenses, primarily associated with our Phone Hardware Restructuring Plan, which together decreased net income and diluted EPS by $8.3 billion and $1.02, respectively.*

(d) *Includes $7.5 billion of goodwill and asset impairment charges related to our phone business, and $2.5 billion of integration and restructuring expenses, primarily associated with our Phone Hardware Integration Plan and Phone Hardware Restructuring Plan, which together decreased net income and diluted EPS by $9.5 billion and $1.15, respectively.*

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation
Redmond, Washington

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the “Company”) as of June 30, 2016 and 2015, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders’ equity for each of the three years in the period ended June 30, 2016. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2016, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of June 30, 2016, based on the criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated July 28, 2016 expressed an unqualified opinion on the Company’s internal control over financial reporting.

/S/ DELOITTE & TOUCHE LLP

Seattle, Washington
July 28, 2016