

Intermediate Financial Management - Group Analysis Paper

Understanding the complexities of financial management within a modern corporate environment is pivotal for comprehending its growth and sustainability. This paper delves into the intricate financial strategies of Microsoft, a leading U.S. tech company renowned for its significant acquisition activity and dynamic management strategies. We will explore three key areas: the company's approach to executive compensation and incentives, its mergers and acquisitions (M&A) strategy, and its methods for risk management. Our investigation aims to provide a comprehensive overview of how Microsoft aligns its financial management practices with its overall business goals, ensuring long-term value creation for its stakeholders. By analyzing the interplay between executive compensation and company performance, assessing the success and rationale behind its M&A activities, and evaluating its risk management techniques, this paper offers insightful perspectives into Microsoft's financial decision-making processes.

Now, let us dive into the first focal point of our examination, analyzing Microsoft's approach to executive compensation and what incentives this structure creates. Through an in-depth analysis of this relationship, our goal is to reveal the company's overarching goals and how this is presented through financial decisions within executive compensation. Microsoft's executive compensation structure is broken down into five components in keeping with others within the industry: Salary, Bonuses, Stock Awards, Non-equity Incentive Plan Compensation, and all Other Compensation. The issued Salaries, as stated by Microsoft, are in keeping with industry standards. Salary ranges from 2.5 million for the CEO to 850,000 for the Executive Vice President, the lowest listed executive. Salary compensation acts more of a baseline, whereas Microsoft's primary focus is on performance-based compensation, especially for its CEO, whose

compensation structure is 95% performance-based measurements. Next, let us explore the field bonuses; bonuses are uncommon in Microsoft among executives, especially with how the company measures performance metrics (elaborated on later). They see performance increases represented as increases in other compensation fields, almost acting as a filler for traditional bonuses.

The next category that contributes to total compensation is "Stock Awards"; this category encompasses two different components: SAs (Stock Awards) and PSAs (Performance Stock Awards). These two components are given equal weights for non-ceo executives; in other words, the compensation category "Stock Awards" comprises 50% SA compensation, with the other 50% being PSA compensation. However, the CEO "Stock Awards" are made up of 100% PSAs. This speaks to the extra weight placed on the CEO's performance on specified metrics; this makes sense since they are at the forefront of the company structuring their compensation entirely on performance. The Shareholders hope this instills a heightened importance for the CEO to work to meet performance metrics. PSAs for Microsoft are measured across a three-year fiscal period, with the most recent cycle ending June 30th, 2023. With a new cycle starting, this year this allows shareholders to modify the areas they see as most essential and will place the highest weight of performance in the key areas they see pivotal in increasing Microsoft's continued success. When looking at Microsoft's priorities as a company, they place 70% of the weight of the PSA categories on Microsoft cloud revenue, Microsoft cloud subscribers growth, and teams' monthly active usage growth, demonstrating that the shareholders planned focus going forward will be on high levels of performance in these areas hence why they base the majority of their executive performance metrics off them. Each category has a specified weight that is applied to the measured performance in that area; these are then all added together to give

the performance threshold for each executive. Microsoft applies this value to the previous year's award to find the increase (or, in extreme scenarios, possible decrease) from last year's PSAs. The results from the PSAs can be modified in cases where relative TSR or Total Shareholder Returns are higher than the 60th percentile when compared to the S&P 500 index. I found this built-in modifier to Microsoft's compensation calculations interesting. After all, it highlights the importance of keeping the board and shareholders happy by incentivizing them with an additional increase by really capitalizing on stock value, which in executive positions other than the CEO advantageously benefits them too because it will translate when their SAs vest. For all other executives, the 50/50 structure still places an importance on keeping up with set targets but offers them more security in SAs. Microsoft SAs vest over four years in this cycle 25% vested on August 31st, 2023, and 12.5% each six months thereafter. Vesting is only redeemable when employment for the individual is continued and is reflective of stock price, placing less focus on overall performance measurements and more on the overall prosperity of the company measured in the form of the current stock value of the company. They have elected this structure believing that striking a balance between SAs and PSAs will keep the interests of the shareholders at the forefront of the mind of executives when making strategic decisions to move the company forward and placing higher weights on areas of the business they would like to see the growth in, alluding to the company's future business plans, instead of using weights in calculating performance metrics and giving some categories higher weight than others.

The category "Non-equity incentive plan compensation" represents the cash incentive awards. The amount of said awards awarded is calculated by looking at two categories: financial and operational assessment. The percent of the total cash award based on financial or operational assessment varies between executive parties. Once again, the main distinction in structure is

between the CEO and all other executives, highlighting the stockholder's belief that the CEO should have a different focus within their role than other executives, being that they are the most crucial named executive. The CEO structure comprises 70% financial assessment and 30% operation assessment; all of the other executives' cash incentives are 50% financial and 50% operational, for reasons much like the "Stock Awards" section. They decided for this year not to increase their target cash incentives for the same reason they decided not to issue any increases in base salaries; they see their current state as an accurate reflection of current performance and in keeping with industry standards. Performance within the scope of "Financial" assessment is measured by comparing actual performance to the internal annual financial goals previously set for the year, with goals being geared towards maximizing revenue and profitability, keeping goals advantageous but hopefully achievable. Targets like such backed by potential compensation rewards are instilled with hopes of motivating executives to make decisions and take appropriate risks to move the company to its outlined targets. Operational assessments are structured differently because operational assessment encompasses three individual areas of focus that are considered when measuring performance in this area. The three areas presented are product & strategy, customers & stakeholders, and culture diversity & sustainability. Each executive contribution to advancements in these three areas is considered when determining the operational performance. An interesting note is that the stockholders make sure to speak with other senior executives when evaluating the CEO's performance in these areas with a specific focus on how they feel about the leadership of the CEO. This presents the idea that Microsoft cares about the satisfaction of its higher-ranking officers, even if they are below the CEO. Evaluations like this cause me to theorize that they care about the cohesion of named executives and that they place value on this, which is an excellent objective to implement because when all

executives are satisfied with their role and higher executive governance, this leads to a well-oiled machine that will only benefit the company both short and long term. Operational and Financial indicators are measured out of a threshold of 200%; the percentages of both areas are then multiplied together. This value then is multiplied by "Individual Target Cash Incentives," this is key in applying the compensation based on meeting targets to each individual executive. This represents the amount an executive can earn in cash incentives, calculated as a percentage of the executive's salary. The final portion of compensation is "All other compensation," which includes vacation accruals, retirement plan contributions, and charitable gifts. This category is relatively straightforward, and amounts are increased by a small percentage each year without much fluctuation or external measurement, gauging how much they should be increased like in the previous areas.

Some exciting takeaways on how Microsoft decides to compensate their executives are, first and foremost, the significant emphasis placed on performance-based compensation, especially for the CEO, implies that Microsoft considers the CEO and other executives' roles and decisions pivotal to the company's success. This is supported by Microsoft talking in their proxy statement about how they aim to create a focus on performance-related compensation to help incentivize executives to act in the best interests of promoting growth. This also makes sense by how much the technology sector is constantly changing and putting a focus on performance keeps Microsoft competitive in such a space. This is evident in the PSA portion of the executive compensation. Providing incentives to maximize stock prices and reach advantageous goals aligns with the analysis that Microsoft wants executives to focus on optimizing performance in various aspects of the company's operations. Another interesting component is how Microsoft approaches calculations in different compensation areas using weights in "Stock Awards"

calculations, emphasizing specific areas, most likely basing these around what they see as their KPIs or key performance indicators, wanting to mirror integral indicators within the compensation structure. The model also provides for more dynamic performance metrics, specifically in the case of PSAs. The different weights not only signify what Microsoft finds its most important areas to be but also allow the company to adjust its performance metrics structure in line with future changes in business goals and allow it to modify categories as markets change over time or new technologies arise. A way to strengthen this compensation inlines with a new cycle beginning this year, Microsoft is starting to see struggles in trying to remain such a big powerhouse in the technology sector. Creating additional incentives through new measures within the PSA measurements and putting an increased focus on strong performance in the AI sector of the business will align their structure of caring deeply about performance with performance areas that will improve the companies long-term growth. This strategic structure aligns with Microsoft's overall developed philosophy of recruiting and maintaining top tier talent, focusing on growth, fostering a culture of meritocracy and a core principle of encouraging employees to continually expand their horizons. By placing a heightened emphasis on performance with executive compensation and potentially adding in more focus on performance with new technologies such as AI signals its commitment to staying at the forefront of technological advancements but also reinforces a culture where merit and innovation are key drivers of success, signaling the company's long-term vision. In summary, Microsoft's executive compensation structure emphasizes performance-based metrics, reflecting strategic alignment with key performance indicators; this allows for flexibility to work toward future business goals and signals a commitment to stay at the forefront of technological advancements. Also, in keeping with a company dynamic to maximize performance and innovation, Microsoft has

worked to make acquisitions it sees as pivotal in keeping up with the ever-evolving landscape of the tech industry.

Furthermore, this focus on performance-based executive compensation reflects Microsoft's commitment to technological leadership and innovation and lays the groundwork for strategic decisions, such as acquisitions, that bolster the company's competitive edge. This strategic alignment is exemplified in Microsoft's approach to expanding its market presence, as seen in its acquisition endeavors, including the notable purchase of Activision Blizzard. Microsoft's acquisition of Activision Blizzard, initially valued at \$68.7 billion and later finalized for \$61.8 billion, represents a strategic expansion into the gaming industry. This move aligns with Microsoft's successful mergers and acquisitions history, aiming to enhance its presence across the gaming industry. The acquisition shows Microsoft's interest in having a more significant presence across various gaming platforms. This acquisition also further solidifies Microsoft as a Tech giant with monopoly-like power across a wide variety of industries.

When tracking shareholder confidence that Microsoft's acquisition of Activision Blizzard would be carried to the finish line, the stock price clearly reflects a wide range of investor emotions on the deal. When the deal was first announced on January 18th, 2022 at \$95 per share, Activision Blizzard's stock rose to 86.90, about a 35% increase, on the very first day, investors were able to act on the news. When assessing where this shareholder confidence came from, many would attribute this to Microsoft's former M&A experience when acquiring game studios and the obvious potential synergies between the two companies. However, despite initial shareholder confidence and excitement, January 18th would remain the stock's peak for over 3 months, notably about 8.5% less than the promised purchase price of \$95.

When researching the reason for this lack of investor confidence, it was largely due to the looming federal antitrust investigation that was mandatory with any multi-billion dollar merger. In the months after Microsoft's intent to acquire Activision Blizzard was announced, politicians with large followings, such as Bernie Sanders, Elizabeth Warren, and Cory Booker, took stances against its formation. The objectors to the deal brought up issues such as the two companies' shared lack of ability to facilitate a healthy office culture as well as the obvious monopolistic implications. As the process ran its course and more negative news about the reality of the deal continued to flow, the stock dropped to a low of 71.51 in November of 2022, Communicating that investors had very little confidence in the deal being done. The Federal Trade Commission (FTC) went as far as to state its intention to block the deal altogether in December 2022.

Even though the FTC's desire to block the deal continued, it became clear to shareholders that the clock was beginning to run out for the FTC to make a real case. This is seen through how the stock steadily rose after bottoming out in November. Microsoft continued to navigate every obstacle until the clock ran out for the FTC. On July 11th, 2023, a judge denied the FTC's request for a permanent injunction on Microsoft, which allowed Microsoft to eventually finish all of the closing points of the deal and officially acquire Activision Blizzard. Shareholder confidence spiked the same day, and the stock then steadied at \$92-\$94 until it was fully bought out on October 13, 2023.

Microsoft's experience in legal and lobbying, notably spending \$1 billion annually in this area, was instrumental in navigating the antitrust challenges. Brad Smith, the president of Microsoft's legal team since 2015, has decades of experience working with governing bodies, politicians, and other influential actors. He has spent his time and resources to try and improve Microsoft's image to make Microsoft seem less like a monopoly to regulators and harp on the

jobs Microsoft creates across industries. Microsoft faced challenges, regulation, and scrutiny from watchdogs and regulators in the US, UK, and the EU but was still able to get the deal across the finish line. Microsoft clearly viewed this acquisition as a way to exponentially increase its intrinsic value both in the short and long term. In order to please UK regulators, they reworked the deal in the 11th hour while simultaneously defeating the FTC in a huge legal battle. The company's adaptability throughout restructuring the deal further showcases its commitment to the acquisition's success.

By integrating Activision Blizzard into Microsoft's More Personal Computing segment, Microsoft is poised for significant growth. The acquisition is expected to drive innovations, expand market reach, and enhance Microsoft's position in the gaming market, contributing to long-term profitability. Through this deal, Microsoft will be able to increase its scale and market share in the gaming industry, allowing it to negotiate better deals with suppliers and partners and reach a wider audience of consumers. In addition, Microsoft and Activision Blizzard have complementary businesses, which creates a number of opportunities to create synergies between the two. For example, Microsoft could integrate Activision Blizzard's games into its Game Pass subscription service, or it could use Activision Blizzard's expertise to develop new gaming technologies. The acquisition also allows for cross-selling opportunities. Both companies have a wide range of products and services that they can cross-sell to each other's customers. For example, Microsoft could promote Activision Blizzard's games to its Azure cloud computing customers, or Activision Blizzard could promote Microsoft's Surface devices to its gamers. The video game industry is also expected to continue to grow in the coming years, driven by the increasing popularity of mobile gaming, esports, and cloud gaming. Microsoft's acquisition of Activision Blizzard will give it access to several high-growth businesses well-positioned to

benefit from these trends. Activision Blizzard also owns some of the most valuable intellectual property in the video game industry, including Call of Duty, Candy Crush, and Warcraft. This intellectual property gain, which regulators were so scared of, will give Microsoft a competitive advantage in the video game market. The acquisition allows Microsoft to generate revenue from various sources, such as game sales, in-game purchases, exclusive console/game deals, and licensing. Microsoft is one of the most financially strong companies in the world. This gives it the resources to further invest in Activision Blizzard's businesses to help them grow. It also gives Microsoft the flexibility to weather any downturns in the video game market. On top of that, Microsoft's M&A experience will allow it to better predict and prepare for any challenges or opportunities in the merger of the two companies.

In conclusion, Microsoft's acquisition of Activision Blizzard is a strategically calculated move, expected to transform its gaming portfolio and ensure continued dominance in the evolving digital landscape. Both companies' history of profitability and product innovation within the industry, combined with Microsoft's proven M&A expertise and ability to overcome regulatory challenges, underscores the potential for significant growth and profitability in the gaming industry. While Microsoft's strategic acquisitions, such as Activision Blizzard, and its impressive growth in cloud computing showcase its innovative and forward-thinking approach, these ambitious moves also introduce various challenges and risks. As the company continues to evolve, navigating these risks becomes crucial to sustaining its market leadership. This leads us to a critical examination of Microsoft's risk management strategies, particularly in the face of intense industry competition and the rapid pace of technological advancement.

Despite Microsoft's mission to empower every person and every organization on the planet to achieve more, many risk factors must be taken into account. Two vital risk factors

consist of strategic and competitive risks and cybersecurity, data privacy, and platform abuse risks. The intense competition within the industry for their products and services can decrease revenue and opening margins. Starting with strategic and competitive risks, an area in the technology sector where competition thrives. Due to the variety of competitors along with the rapid evolution of technology and consumer preferences, this poses a significant challenge for the company. Managing these rapid changes requires Microsoft to focus on innovation and having the latest technology versions catering to consumers and businesses. Microsoft is notorious for their struggles to innovate throughout recent years; the past 10 years have been fundamental for major technological advances including the use of Web 3.0. For a long time, the company held on to the mentality of appealing to customers who are happy with the original versions of their technology consisting of MP3 players, gaming consoles, Webcams, and multimedia Web developments. The primary focus should not be on adjusting products that were once popular but rather on solving problems that are revolutionary to modern technological advancements that others are unable to solve. Microsoft's shifting to cloud computing as a primary service is a great start; the enterprise cloud infrastructure market is forecasted to surpass \$250 billion this year. This shift has ignited the growth of their Intelligent Cloud Computing platform. 2017 is when Microsoft first earned a substantial revenue increase of roughly \$23 billion from implementing this operation. This has grown exponentially ever since: 2018 increased to \$30 billion, 2019 to \$39 billion, 2020 to \$45 billion, 2021 to \$60 billion, and 2022 bringing in roughly \$77 billion. Today, this makes up 40% of the company's income and a quarter of their global cloud infrastructure market.

Business model competition is another factor taking on a large fraction of the company's risk. These models consist of license-based proprietary software, free apps supported by

advertising, and open-source alternatives. Microsoft plans to mitigate this risk by utilizing artificial intelligence (AI). According to Forbes, an external analysis of Microsoft that recorded 31,000 workers and trillions of Microsoft 365 productivity signals, 2 in 3 workers struggle to free up time for innovation and strategic thinking. This is because workers are flooded with daily tasks that are rather dull, and can be rationalized by using technology that will efficiently clear up some of that time, allowing workers to prioritize more critical tasks. Implementing AI will also help Microsoft stay responsive to technological changes and any regulatory developments that pop up, allowing the company to keep up with the competition and adapt to future changes. Microsoft reported in their safety policies, "We implement a layered approach, mapping, measuring, and managing risks of harm and misuse as AI is developed and deployed across the technology architecture, including at the model, API service, and application layers, working in collaboration with OpenAI, which provides Microsoft frontier models that we make available via platform services and leverage in applications" (Microsoft Corporate Blogs). Using caution every step of the way, Microsoft incorporating AI within their company will increase overall efficiency and create a more productive work environment while keeping operations appropriate and ethical.

While there are many risks related to strategic and competitive risks, the recent use of cybersecurity, data privacy, and platform abuse also imposes vital risks. For example, cybersecurity is a constant threat in a technical industry such as this one. There are perpetual threats of cyberattacks from hackers and intruders in market-leading businesses such as Microsoft. An example of a cyberattack that made history was in 2019 with Adobe, a multinational software company. This breach leaked the user's records database from their Creative Cloud Service, giving access to this service to anyone with the password or

authentication. Having phished roughly 7.5 million Adobe Creative Cloud user accounts, the scammers disclosed email addresses, account creation date, subscribed products, subscription status, member IDs, country, time since last login, and if the user is an employee. In response, Adobe shut off public access to the database, leaving uncertainty within millions of user accounts. This act starts with phishing activity and then leads to criminals tricking users into giving up their personal information, usually financial information. Microsoft investing in top-tier security of products and services, cyber threat detection, and reliability features will detect any threats before it is too late. This is a costly investment that may affect operating margins, but worth every penny to safeguard customer data and uphold Microsoft's reputation from potentially losing billions of dollars and disclosing personal information. Security of products, services, and data is crucial for customer trust and decision-making.

Microsoft handles this by offering third-party components, leaving room for security breaches and legal claims against them. They recognize the challenges associated with maintaining security within a wide range of third-party products. To keep up with these security risks, Microsoft must produce secure products, provide security tools, and innovate with the evolving cybersecurity regulations. Otherwise, it opens room for disclosure and misuse of personal data internally and externally. Microsoft stores and processes large amounts of personal data, raising the risk of breaches and misuse of customer data. Misusing this data can lead to legal exposure, reputational harm, and increased costs. As a result of that, Microsoft is a strong advocate for keeping things transparent, limiting access to sensitive data, and properly training employees and third parties on the importance and fundamentals of data security. To protect their products, Microsoft has partnered with public and private companies to ensure a strength-in-numbers policy and protection from hackers.

The abuse of Microsoft's platforms impose another risk such as impersonations and publishing misleading information. In 2023, Microsoft was affected by a security breach. An attacker forged authentication tokens. The hackers obtained emails from roughly 25 organizations, government agencies, and customer information found in the public cloud; however, the target was directed towards government agencies. The attack was first recorded this past June but started mid-May when Consumer Signing Systems crashed, leaving open access to Microsoft's cloud. This requires hefty investments in specialized protectors and technology, and there must be a balance between catering to these platforms and mitigating this abuse. Microsoft has a yearly investment of \$4 billion in cybersecurity to protect all undisclosed information. In their digital defense report, Microsoft prioritizes multi-factor authentication, zero trust principles to limit the impact of an attack, extended detection and response, and antimalware to block attacks and provide insights to their software operations, as well as staying up to date. Overall, these two categories impose two of the most prominent risk factors within Microsoft for 2023, and the company's commitment to mitigating these risks will significantly impact not only their future but Activision Blizzard's as well. Adapting to a constantly evolving environment is imperative to stay a market leader like Microsoft. All in all, risk management is one of the many factors that must be taken into account for not only the company's overall success but successfully merging with another company as well.

As we conclude our analysis of Microsoft, it becomes evident that the company's financial management strategies are a cornerstone of its corporate success. The company's executive compensation and incentive schemes are strategically designed to align with its long-term goals, fostering a culture of performance and accountability. The analysis of its M&A strategy reveals a deliberate and calculated approach, reflecting the company's commitment to

strategic growth and market expansion. Furthermore, Microsoft's approach to risk management underscores its resilience and adaptability in the face of market volatility and operational uncertainties. Overall, our comprehensive study of Microsoft highlights the intricate connections between different aspects of financial management and showcases the importance of these strategies in shaping the company's future trajectory. The insights garnered from this analysis contribute to a deeper understanding of effective financial management in the context of a rapidly evolving business landscape.

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