

# Microsoft Corp Announces Changes to Financial Reporting Structure

## Company Participants

- Chris Suh, General Manager of IR
- Frank Brod, CAO

## Other Participants

- Daniel Ives, Analyst, FBR Capital Markets
- Kirk Materne, Analyst, Evercore ISI
- Mark Moerdler, Analyst, Bernstein Research
- Michael Turits, Analyst, Raymond James

## Presentation

### Operator

Greetings. Welcome to the Microsoft segment conference call.

(Operator Instructions)

As a reminder, this conference is being recorded.

I would now like to turn the call over to Chris Suh, General Manager Investor Relations. Thank you. Chris, you may begin.

### Chris Suh {BIO 17955231 <GO>}

Thank you, Jesse. Good morning, everyone. And thanks for joining us on the call today. With me Frank Brod, Chief Accounting Officer.

Today's call is being webcast and recorded. If you ask a question, it will be included in our live transmission, in the transcript. And any future use of the recording. You can replay the call and view the transcript at the Microsoft Investor Relations website until September 29, 2016.

During this call, we will be making forward-looking statements, which are predictions, projections or other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's conference call. And in the risk factors section of our Form 10-K, Form 10-Q.

And other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

Yesterday afternoon we announced our new reporting segments. On our call today, we will review these segments in more detail. And also discuss what you should expect with our First Quarter earnings release in October. On our website, [Microsoft.com/investor](http://Microsoft.com/investor), is our slide deck, which is intended to follow today's discussion. Additionally, you can also find today's 8-K filing and our recast historical quarterly segment results on our website.

We will not be discussing any topics other than segments on the call today. Our First Quarter FY16 earnings call is scheduled for October 22. And we'll provide results for the quarter at that time.

To start us off, I'm going to turn the call over to Frank.

**Frank Brod** {BIO 3446588 <GO>}

Thank you, Chris. Good morning, everyone. As many of you know, accounting and disclosure rules require that Microsoft report its financial results in the same manner in which our CEO analyzes performance and allocates resources. During this quarter, we've worked with our CEO to align our internal reports, our scorecards. And our accountability framework with Microsoft's three interconnected ambitions. As Chris noted, yesterday we announced our new financial reporting segments. We will report our results in these new segments beginning with our First Quarter of FY16.

For those following along in the slides, I'm going to talk to slide 4. For each of our new segments, we will report both revenue and operating income performance, providing insights into our progress in each of the three ambitions. Our new segment profit performance measure will be operating income to reflect resourcing decisions that consider both the cost of sales and operating expenses. In this way, it is a full measure of accountability that reflects the changes that we are making in how we manage the Business. To the extent that gross margin is a material driver of segment operating income results in a period, it will be discussed in earnings materials and in the MD&A section of our filing.

Our first segment is Productivity and Business Processes, which aligns to our ambition to reinvent productivity and business processes. To do this, our products and services will span a variety of devices and platforms. And include productivity, communication and information services such as Office, Office 365, Dynamics, Exchange, SharePoint and Skype. We are looking to drive scale and usage with dual-use customers. Therefore, this segment includes revenue from both consumers and commercial customers.

Our second segment is Intelligent Cloud, which reports on our ambitions to build the intelligent cloud platform. With our core infrastructure, data platform and server application, both on premise and in the cloud, we will provide our customer with improved agility and insight. And solutions that they can use to differentiate their

business. As applications are developed on our cloud platform they are able to attach our differentiated solutions for identity and data management, as well as machine learning and advanced analytics.

Our third segment is aligned with our ambition to create more personal computing. And is aptly named More Personal Computing. Through our Windows device platform and our own devices we will look to generate more opportunity for the Windows ecosystem and enable new product categories. Additionally, we look to improve the distribution of services such as search, while expanding gaming to one integrated experience across devices.

On slide number 5, for those of you who are following along, the three segments are presented along with the major product and service categories that comprise each segment. By moving to these three segments we are providing transparency in our progress against our ambitions while simplifying our reporting structure. One example is Office products and services, which were previously reported in four segments but now are included in a single segment, Productivity and Business Processes. And in the More Personal Computing segment, by including both the initial Windows platform royalty license revenue, as well as post-sale monetization through services such as search and gaming, we are giving visibility into the performance of the broader Windows ecosystem as Windows 10 gains traction and share.

We will continue to have a segment category named Corporate and Other. One-time revenue deferrals and recognitions such as tech guarantees and pre-sales prior to the general availability of our new products are recorded here, as well as the net impact of Windows 10 revenue deferrals. Corporate-level expenses that are not attributable to a segment will also be reported in Corporate and Other.

I'll now turn the call back over to Chris who will provide further details.

**Chris Suh** {BIO 17955231 <GO>}

Thanks, Frank. In order to help you update your model from the old reporting segments to the new, we'll now walk through the product mapping in detail. For this discussion, I'll use Fourth Quarter FY15 results for the mapping, unless otherwise noted. You should be able to leverage this to extrapolate to other periods. And all percentages given are approximate.

I'll start with slide 6, beginning with Devices and Consumer Licensing. The majority of this segment will now be reported in More Personal Computing. In Q4, about 75% of the revenue was from the sale of Windows, primarily through our OEM partners. And about 10% was from the licensing of Windows phone and related intellectual property. All of this revenue will now be reported in the More Personal Computing segment. The exception is revenue from the traditional licensing of Office Consumer, which will now be reported in the Productivity and Business Processes segment.

On slide 7, revenue from our two hardware segments, Computing and Gaming Hardware. And Phone Hardware, will all be reported in More Personal Computing.

Moving to slide 8, the Devices and Consumer Other segment was primarily comprised of Search and Display Advertising, Xbox LIVE and 1st Party Games. And Office 365 Consumer. The vast majority of these results in this segment, about 90%, will be reported in More Personal Computing. Search Advertising was about 40% of the segment's revenue; Display Advertising was 10%; and Xbox LIVE, transactional revenue and 1st Party Games was another 40%. And all will be reported in More Personal Computing. Office 365 Consumer, which was about 10% of the segment, will be in the Productivity and Business Processes segment.

Switching now to Commercial Licensing segment on slide 9, server products licensed on premise, which was roughly 45% of the segment's revenue, will now be reported in Intelligent Cloud. And similarly, traditional licensing of Office commercial products, which was about 40% of the revenue. And our Dynamics business, about 5%, will be in Productivity and Business Processes. The last major component is the volume license sales of Windows. And that will be reported in More Personal Computing.

Finally, in our Commercial Other segment, the revenue mix was approximately 60% commercial cloud and 40% enterprise services. Within commercial cloud, Office 365 Commercial and Dynamics CRM Online will both be reported in Productivity and Business Processes. Azure and Enterprises Services will be reported in Intelligent Cloud. That completes the detailed mapping of the old segments to the new.

Slide 11 is a clean view that summarizes where our products and services are reported in both the old and new segments. One aspect of the new mapping that will undoubtedly stand out is that this brings together the traditionally licensed products with their cloud counterparts, improving the visibility into the combined financial performance as customers transition and adopt cloud services.

Moving to slide 12, as most of you know, with each quarterly earnings release we share our results in a variety of ways, including our earnings press release, a slide deck of our results, our earnings conference call. And in the MD&A section of our quarterly filings. Across these various components, we provide actual financial results, as well as the material drivers of business during the quarter. Additionally, on our IR website we publish a set of quarterly metrics that supplement the information we provide in the earnings release and MD&A. The goal of these metrics is to provide additional insight that helps you understand our results. And also to gauge the progress we're making against our ambition.

On slide 12, you'll first notice that we've designated a set of metrics that cover our commercial business results across Microsoft. This is in addition to specific metrics within each reporting segment that are also commercial oriented. I want to emphasize the insight and transparency into the performance of our commercial business that we will provide. Though we no longer have specific commercial

segments, we have updated our metrics to more easily communicate the health of our entire commercial billing cycle, including commercial bookings, unearned revenue, contracted not billed. And commercial annuity revenue mix.

Next, we'll continue to publish a set of segment-specific metrics. Since many of these are not new, I'll only focus on the ones that have changed. The first is Office 365 Consumer subscribers. In the past, we've provided this metric as a growth percentage, while occasionally providing the subscriber count in other earnings materials. Going forward, the metric will reflect the subscriber count.

The second metric that is changing is the addition of Xbox LIVE active users that replaces the Xbox console unit metric. Console sales will continue to be provided in other earnings materials when they are a driver of changes in revenue and operating income. The addition of Xbox LIVE active users demonstrates the opportunity that we see to extend our gaming assets beyond the living room to PCs, tablets, phones and other form or factors with Windows 10. And is more aligned to our long-term opportunity.

Third, we've been disclosing our Commercial Cloud annualized revenue run rate for a few quarters now. And going forward, it will be a quarterly metric, meaning you can expect to receive this number with each earnings release.

The final change I want to walk you through is the metric definition for search advertising. With the transition of search advertising sales to Microsoft and the amended Yahoo agreement, we've adjusted the quarterly metric to be revenue, less traffic acquisition costs, which is a better indicator of Bing search advertising revenue growth going forward.

As you look through the complete list of metrics, as mentioned, we will continue to be very clear about the performance of our commercial results within each reporting segment, too, with Commercial Cloud, Office Commercial, server products and services. And Windows volume licensing and Dynamics metrics all still readily available. Through our comprehensive reporting framework, the reporting of our results with our new segments aligned to our three ambitions, the disclosures in our earnings materials. And the details provided in our SEC filings. And all of this supplemented with our quarterly metrics, we will continue to work to provide investors with best-in-class transparency into our business results. And key drivers of our progress and performance.

Before taking questions, I'll walk through what you should expect from us in the coming weeks as we move to the new reporting segments. On October 22, we will report our First Quarter FY16 results. And these results will be presented in our three new reporting segments. This includes all filings, commentary. And any forward-looking guidance.

To ease the transition and bridge back to any forward-looking statements that we made last quarter, we will provide a supplemental table of the Q1 results in the old

segment view as well. In late October, we anticipate filing an 8-K to recast previously reported amounts into the new segments.

So with that, Frank and I will take some questions. Again, please limit your questions to items covered only in today's call. Jesse, please go ahead and repeat your instructions.

## Questions And Answers

### Operator

(Operator Instructions)

Mark Moerdler, Bernstein Research.

### Q - Mark Moerdler {BIO 16855032 <GO>}

Thank you very much. Thank you. You've given a lot of information that will hopefully help people and be able to understand it. Now that you're making the change and you've gone from gross margin to operating margin -- gross margin did give you some sense of clarity as to what's happening with the hosting costs of the cloud -- are we going to get any additional data that will give us a sense of the improving margins of the cloud from a purely hosting point of view as you gain scale and efficiency?

### A - Frank Brod {BIO 3446588 <GO>}

Mark, this is Frank. First of all, we have to report our profit indicator in the way in which our leadership looks at the results. Our team focuses on accountability on operating income as the basis for their resource decisions and for their performance analysis. We see it as a full measure of profitability as we progress towards our ambitions.

We will continue to disclose gross margin and gross margin changes when it's a material driver of results. Gross margin is an important component of operating income so it is something that we'll speak to in explaining where our results came out in any given period.

### A - Chris Suh {BIO 17955231 <GO>}

And Mark, if I could just add on, specific to your cloud question, as you know, previously we didn't disclose commercial cloud gross margin specifically but it was part of commercial other and you were able to see generally how the performance of our gross margin progress was. We talked a little bit about specifically commercial cloud gross margin in periodic points when we reach milestones and that is how I anticipate we will talk about it going forward. We do anticipate that we continue to make forward progress in improving that gross margin. And as we hit relative milestones we'll continue to talk about it to the extent that they are driving our performance results.

**Q - Mark Moerdler** {BIO 16855032 <GO>}

Perfect. Thank you. And thanks again for the additional information and the metrics.

**Operator**

Daniel Ives, FBR.

**Q - Daniel Ives** {BIO 3704239 <GO>}

From the perspective internally, what do you think the new reporting structure adds from a transparency perspective, especially the Windows 10 as well as the cloud initiatives? Maybe you could just talk about that from a high level; how it is going to make it easier even internally to look at your results.

**A - Chris Suh** {BIO 17955231 <GO>}

Thanks, Dan. Thanks for the question. It is a good question because for those who have been following the Company for a while, Satya has, as he's evolved his role as CEO, he has clearly been focused on these ambitions as priorities for the Company. And I think the way that the new reporting aligns to those ambitions provides great transparency and accountability toward the progress against those ambitions.

You talked about Windows specifically. With Windows 10, the notion of the ability to monetize after the initial license sales through the PC is an important concept and one that we have more clear alignment and transparency toward with these new reporting segments.

**Q - Daniel Ives** {BIO 3704239 <GO>}

Great. Thanks.

**Operator**

Kirk Materne, Evercore.

**Q - Kirk Materne** {BIO 5771115 <GO>}

Thanks very much and I'll echo, thanks for the additional details on this new breakout. Chris or Frank, could you talk a little bit about commercial, in general, meaning you are now mixing commercial with consumer on the productivity side? And are we going to get any updates in terms of commercial as a total percentage?

The only thing I would say about the new combination is I would think that you would still think about the office commercial business a little bit differently than the office consumer internally. So are going to get any updates on that? Or within the productivity bucket, any idea of what percentage of that is more annuitized because actually you've got, we had the annuity breakout of commercial. And now commercial is spread across a couple buckets? So mainly just trying to get a sense of

how we should be thinking about commercial in general and then annuity with this new structure around the productivity segment. Thanks.

**A - Chris Suh** {BIO 17955231 <GO>}

Thanks, Kirk. Commercial is an important construct. I know clearly that investors view the commercial side of our business as an area of focus, as well. We're taking a number of steps to make sure that we maintain good transparency and visibility into the commercial results.

To address a couple of the points you made specifically, within the Business Productivity and Processes segment, we will be reporting through our KPI structure and in the MD&A of our 10-Q the performance of Office commercial separate from Office consumer. So that will be very visible within the segment construct, as well.

Then, secondly, through our KPIs we will have a list of KPIs that are labeled specifically commercial that will have the commercial annuity revenue mix, which is one that you referenced, as well as our commercial bookings, our commercial unearned revenue and our commercial contracted not billed. I do believe that even with the new segments, while we simplify it in many ways by putting the product families together, we maintain the visibility and transparency to all of our results regardless of whether they are sold to commercial or consumer customers.

**Q - Kirk Materne** {BIO 5771115 <GO>}

Thanks, Chris.

**Operator**

Michael Turits, Raymond James.

**Q - Michael Turits** {BIO 1720659 <GO>}

Hello, guys, thanks very much. Two questions. One, any change that you can tell us about in the way that you'll be giving guidance. And inclusive of that whether you will be giving COGS guidance, as well. Then a second question is, just as commercial and consumer is blended in these segments, as you pointed out, both cloud and on-prem are blended. Is there anything you're going to be doing to help us understand a little bit better the transition to cloud, both from a revenue and margin perspective?

**A - Chris Suh** {BIO 17955231 <GO>}

Thanks, Michael. A couple of things. On guidance, structurally I don't anticipate that we'll be changing the way that we give guidance. In other words, we have been giving guidance with each segment, the revenue guidance for each segment. And we gave previously COGS number for the entire company all up, as well as operating expenses all up. I do anticipate that we will follow a similar structure. And you'll hear more from us on October 22 when we talk about the First Quarter as well as any forward-looking statements.



Then to your second question in terms of our cloud performance versus our on-prem performance, there's two ways that I think you'll be able to get transparency on that. One is that we will continue to publish and report on our commercial cloud revenue annualized revenue run rate in total. So you'll be able to see that consistent with the way that we've reported it in the past. You'll be able to see the aggregate performance of our commercial cloud, which is Office 365, Azure, CRM online, as well as some of our new finished applications that fall into the Azure family.

Secondly, we historically publish KPIs that report on both the combined performance of Office, what we call products and services, which means on-prem plus the cloud, server products on-prem plus in the cloud, Dynamics on-prem plus the cloud. And will continue to publish each of those KPIs so you can see the aggregate performance growth on revenue for both on-prem and sold through a variety of cloud services. So you will be able to see that there. Then I would look for additional discussion within our MD&A in the SEC filings. To the extent that they're material drivers of our results we will continue to publish that.

Then, finally, our earnings slide deck is always rich with information that provides additional breakdown of performance across all of our segments and we'll continue to keep those on our website, both historically and going forward. And I would recommend that you read through that to see detailed discussion about performance within a segment, as well. So I think there's a variety of places you will be able to get pretty good transparency into that.

**Q - Michael Turits** {BIO 1720659 <GO>}

Okay. Thanks, Chris. Thanks, Frank.

**A - Chris Suh** {BIO 17955231 <GO>}

Thanks, Michael. With that, I think we wrap up the call and the Q&A portion of today's call. I want to thank you all for joining us. If you have any questions as you are updating your models please reach out to the IR team and we will be happy to help where we can. Thanks again for joining us today.

**Operator**

Ladies and gentlemen, this does conclude today's teleconference. We thank you for your participation. And you may disconnect your lines at this time.

*This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of*

---

*the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2024, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.*