Microsoft

Annual Report 2018

Dear shareholders, customers, partners and employees:

As I reflect on our progress this past year, I first want to say thank you for your commitment and investment in Microsoft. I'm proud of what we've accomplished together as we innovate and help customers navigate their digital transformation, and I am even more optimistic about the opportunity ahead.

We are living at a crucial time in history where the impact of technology on every part of our daily life and work and every aspect of our society and economy is more acute than ever before. It is incumbent upon leaders of our industry to ensure that the technology we build always creates opportunity. Too often, we celebrate technology disruption for the sake of disruption without reflecting on its unintended consequences. What the world needs is technology that benefits people and society more broadly and is trusted.

Our mission is to empower every person and every organization on the planet to achieve more. Our business model is dependent on our customers' and partners' success. We are grounded in creating local economic opportunity in every community, helping to unlock the power of technology to address our customers' most pressing challenges. Our platforms and tools enable creativity in all of us. They help drive small-business productivity, large business competitiveness and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity. Our sense of purpose lies in our customers' success.

Our culture enables us to pursue our mission with a growth mindset. It's a continuous practice of learning, renewal and having the courage to confront our own fixed mindsets. Collectively, we are moving from a group of people who know it all to a group of people who want to learn it all. To achieve our mission, we must reflect the diverse perspectives and experiences of our customers around the world. We must have a deep sense of their unmet and unarticulated needs. Each day we are pushing ourselves to be more customer obsessed, to be more diverse and inclusive, and to operate as One Microsoft – ultimately to make a bigger difference in the world.

OPPORTUNITY AND IMPACT

One of the greatest privileges I have as CEO of Microsoft is seeing firsthand the incredible impact our technologies have on people and organizations around the world. Our ecosystem touches the lives of billions of people every single day, creating new opportunity for our customers and partners and positively impacting local communities.

In Kenya, our partner M-KOPA Solar has connected hundreds of thousands of homes across sub-Saharan Africa to solar power for the first time using the Microsoft Cloud, innovating with a pay-as-you-go model that helps households living on less than $2 a day establish a credit history. In Arizona, we are applying Dynamics 365 to improve outcomes among one of the state's most vulnerable populations – the more than 15,000 children in foster care. In Poland, MedApp is using HoloLens to help cardiologists visualize a patient's heart as it beats – in real time – reducing the amount of time they then need to perform open-heart surgery. In Kona, Hawaii, Jack's Diving Locker is using Microsoft 365 to connect its 50 employees across land and sea so that they can focus on what they do best – protect pristine coral reefs and take people diving. In Washington state, Karrick Johnson, an 8-year-old with dyslexia, avoided reading in class until he started using our Learning Tools. And in Cambodia, underserved children in rural communities are learning to code with Minecraft, opening doors to futures that would have previously been unimaginable.

Across the globe, enterprise customers in every industry – from iconic brands like Coca-Cola Company and Chevron Corporation to ZF Group, a car parts manufacturer in Germany – are using our technology to build their own digital capability so they can thrive in a world where every company is a software company. Walmart – the world's largest company by revenue, and its biggest private employer – chose Azure and Microsoft 365 to fuel its digital transformation, transforming the shopping experience for customers and empowering their more than 2 million associates to do their best work.

In sum, our platforms create broad surplus everywhere, from the farmer who is able to apply precision agriculture to conserve resources and increase yields, to the hospital that is able to lower the cost of healthcare and improve patient outcomes, to the largest companies of the world reaching new customers in new markets.

RESULTS AND PROGRESS

The breadth and depth of our mission and the trust customers are placing in us to power their digital transformation enable us to have this broad impact – and it is fueling our results.

In fiscal 2018, we delivered $110.4 billion in revenue and $35.1 billion in operating income and returned $21.5 billion to shareholders through dividends and share repurchases.

Our commercial cloud business delivered more than $23 billion in revenue, exceeding the ambitious goal we had set to achieve $20 billion in annualized commercial cloud revenue by the end of fiscal 2018, nine months ahead of schedule. In addition, we expanded our commercial cloud gross margin to 57 percent, up 7 points year-over-year.

These are strong results – and yet the opportunity ahead in a world powered by an intelligent cloud and edge is unprecedented. Imagine a future where all of your apps and experiences revolve around you and transcend any single device; where data in any form is analyzed in real time so that computers can anticipate and even act on your behalf and augment what you would otherwise be able to accomplish on your own. And where computing is more distributed and embedded in the world, from intelligent digital assistants at work, on the go and in your home that you can communicate with in a myriad of ways – voice, eyes or gestures – to oil rigs that adjust production in real time as demand fluctuates in global markets.

Across each of our customer solution areas, we are broadening our offerings and accelerating our innovation to capture the opportunities this new era will create for our customers and better meet their unarticulated needs.

Modern Workplace

We expanded our Microsoft 365 offerings to reach new audiences and empower more employees for the modern workplace, protecting data from increasingly sophisticated cybersecurity threats and delivering secure productivity and collaboration tools. Already a multi-billion-dollar business, Microsoft 365 gives customers a path to the cloud and broadens our reach with new and under-penetrated markets – from Fortune 500 enterprises to small businesses to more than 2 billion firstline workers. More than 135 million people use Office 365 commercial every month, and Outlook Mobile is helping people be productive and stay secure on more than 100 million iOS and Android devices worldwide – with AI-infused experiences they use every day. Microsoft Teams has rapidly become the hub for teamwork and is being used by more than 300,000 organizations of all sizes, including 87 of the Fortune 100. Windows 10 is now active on nearly 700 million devices around the world. And we continue to create new device categories with always-on, always-connected Windows 10 PCs and an expanded family of Surface devices including the new Surface Go – setting the bar for the industry.

Business Applications

Every process inside a business is being digitized, and we are winning customers with our differentiated approach, enabling organizations of all sizes to digitize critical business functions – from sales to marketing to HR. Dynamics 365 is the alternative to monolithic, siloed suites of business applications with modular, extensible and AI-driven apps that are part of a connected data graph and unlock insights across every part of the organization. Net seats grew 52 percent year-over-year, and our investments in Power BI have made Microsoft the leader in business analytics in the cloud. Our recently announced Open Data Initiative with Adobe and SAP will enable our customers to take control of their data and build new experiences that truly put people at the center. And we are innovating with HoloLens and mixed reality to create immersive experiences that digitize physical spaces and interactions to transform training, collaboration and design for firstline workers, who account for 80 percent of the world's workforce.

LinkedIn is the essential platform to connect the world's professionals and create economic opportunity for every member of the global workforce. LinkedIn now has more than 575 million members, and we are continuously innovating to give them new ways to connect and engage with one another – from increasing the relevancy of the LinkedIn Feed to a better mobile experience, to introducing new video and messaging capability. And we are transforming how companies manage talent, training, and sales and marketing with new solutions powered by the LinkedIn and Microsoft Graphs. Dynamics 365 for Talent with LinkedIn Recruiter and Learning gives HR professionals a complete solution in an increasingly competitive talent marketplace, and deep integration of LinkedIn Sales Navigator and Dynamics 365 redefines social selling, enabling sales professionals to dramatically increase their effectiveness by drawing on the relationships in their personal networks. We will continue to innovate across the LinkedIn platform to add new value for members and customers.

Applications and Infrastructure

To thrive in the era of the intelligent cloud and intelligent edge, customers need a consistent computing stack from the cloud to the edge. Azure is the only hyperscale cloud that extends to the edge across identity, data, application platform, and security and management – and this architectural advantage is increasingly clear to our customers. Azure revenue grew 91 percent year-over-year.

And we are investing aggressively to build Azure as the world's computer. We expanded our global datacenter footprint to 54 regions – more than any other cloud provider – and with the most comprehensive compliance coverage in the industry to meet evolving regulatory needs, creating broader economic benefit and opportunity in local markets on six continents. With Project Natick, we even innovated beyond land, experimenting with a full-scale subsea, zero emissions datacenter with the promise of setting new standards for datacenter provisioning, latency and sustainability.

We added nearly 500 new Azure capabilities in the past year alone, focused on both existing workloads and new workloads such as IoT and Edge AI. IoT is transforming the rules of manufacturing, retail, and oil and gas – fueling cloud and edge innovation, accelerating the evolution of digital factories and enhancing supply-chain performance. Azure IoT and Azure Stack – a first-of-its-kind cloud-to-edge solution – enable customers and partners to build IoT solutions that run at the edge, so people from the factory floor to the retail store to the oil rig can manage devices and analyze data in real time. We introduced Azure Sphere, another first-of-its-kind, highly secure edge solution that combines chip design, an IoT operating system and a cloud service to secure the more than 9 billion microcontroller-powered devices entering the market each year – from kitchen appliances to industrial equipment. It's an incredible example of how we are helping our customers realize the promise of a world of connected devices and things. And, our ambition extends beyond today's computers to quantum computing to take us beyond the limitations of traditional, transistor-based computers and enable entirely new scenarios. We first unveiled our vision for quantum last year, and we are already seeing customers apply our quantum-inspired algorithms to address some of their most pressing challenges.

Data and AI

Our customers will increasingly need to build their own AI to extract insights from the ever-increasing amount of data they collect – and we are investing to make Azure the best cloud for their comprehensive data estates. We are democratizing data science and AI with Azure Cognitive Services, Azure Machine Learning and data services such as Azure Cosmos DB – the first globally distributed, multi-model database – to help organizations of all sizes convert their data into insights and experiences for competitive advantage. In less than a year, Azure Cosmos DB has already exceeded $100 million in annualized revenue. Azure Database for MySQL and PostgreSQL makes it even easier to bring open source-powered applications to Azure, expanding our opportunity in this space. And we are seeing rapid customer adoption of Azure Databricks for data preparation, advanced analytics and machine learning scenarios. We are leading in the field of AI research, achieving human parity with object recognition, speech recognition, machine reading and – this year – language translation. But that is not enough. We are committed to translating these breakthroughs into toolsets our customers can use. More than 1 million developers have already used our Cognitive Services to quickly and easily create AI applications. Our Azure Bot Service has nearly 300,000 developers, and we are driving new advances in our underlying cloud infrastructure, building the world's first AI supercomputer in Azure. Microsoft Translator brings AI-powered translation to developers where their data is, whether in the cloud or on the edge. Our pending acquisition of GitHub recognizes the increasingly vital role developers will play in value creation and growth across every industry, and will enable us to bring our tools and services to new audiences while enabling GitHub to grow and retain its developer-first ethos.

Gaming

We are pursuing an expansive opportunity in gaming – from the way games are created and distributed to how they are played and viewed – surpassing $10 billion in revenue this year for the first time. We are investing aggressively in content, community and cloud services across every endpoint to expand usage and deepen engagement with gamers. Xbox Live now has 57 million monthly active users, and we are investing in new services like Mixer – which blurs the line between watching and playing – and Game Pass, our new unlimited subscription service. The addition of five new gaming studios this year bolsters our first-party content development to support our fast-growing gaming services. And our acquisition of PlayFab accelerates our vision to build a world-class cloud platform for the gaming industry across mobile, PC and console. I'm excited about our opportunity in the fast-growing $100 billion gaming market and what's to come.

TRUST AND RESPONSIBILITY

At a time when digital technology is transforming every industry and every part of our daily life and work, our customers are increasingly looking for a partner whose business interests are fundamentally aligned with their own. At Microsoft, our customers' interests are core to our success. That is what engenders trust.

This commitment extends to instilling trust in technology across everything we do. We believe that privacy is a fundamental human right, which is why compliance is deeply embedded in all our processes and practices. We extended the data subject rights that are at the heart of General Data Protection Regulation (GDPR) to all our customers around the world, not just those in the European Union, and advocated for the passage of the CLOUD Act in the U.S.

Cybersecurity is the central challenge of the digital age, and we are innovating to provide end-to-end security for our customers with security operations at global scale that analyze more than 6.5 trillion security signals each day, enterprise-class technology, and broad cybersecurity partnerships for an increasingly complex and heterogeneous world. We led the Cybersecurity Tech Accord, which has been signed by 61 global organizations, and are calling on governments to do more to make the internet safe. We announced the Defending Democracy Program to work with governments around the world to help safeguard voting, and introduced AccountGuard to offer advanced cybersecurity protections to political campaigns in the U.S.

And, as we make advancements in AI, we are asking ourselves tough questions – like not only what computers can do, but what *should* they do. That's why we are investing in tools for detecting and addressing bias in AI systems and advocating for thoughtful government regulation.

We also have a responsibility as a company to empower everyone to fully participate in our society and economy using technology. We are working with governments, the private sector and local nonprofit organizations around the world to make this vision a reality. We donated more than $1.4 billion in software and services in fiscal 2018, via Microsoft Philanthropies, helping nonprofits get access to the technology they need to drive greater impact, and in calendar year 2017 our employees donated a record $158 million (including company match) through our employee giving program to support nonprofits in local communities.

We are putting AI tools into the hands of change-makers to address society's most pressing challenges with new programs like AI for Earth, a five-year, $50M commitment to environmental sustainability, and AI for Accessibility to benefit the more than 1 billion people with disabilities around the world. I am inspired by how teams across Microsoft are galvanized around inclusive design and accessibility – and producing tangible results, with new features and offerings for Microsoft 365, Office 365, Windows and Xbox designed to meet the needs of people with disabilities.

Finally, we know that the jobs of today will not be the jobs of tomorrow and are investing to provide today's workforce and future generations with the digital skills they will need to succeed, partnering with nonprofit organizations across 54 countries to provide computer science learning experiences to millions of young people around the world and expanding our TEALS program in high schools across the U.S.

I'm proud of our progress, and I'm proud of the more than 100,000 Microsoft employees around the world who are focused on our customers' success in this new era. We have long recognized that the health, wellbeing and diversity of our employees help Microsoft succeed. That's why we provide industry-leading benefits for our employees, including comprehensive health and wellness programs for families, paid vacation, paid sick leave and paid time off for new parents. We were one of the first companies to require our U.S. suppliers doing substantial business with us to provide paid time off for their employees. And this year we took a further step to ensure that these suppliers also provide their employees with paid parental leave.

Over the past year, we have made progress in building a diverse and inclusive culture where everyone can do their best work. Since FY16, we have nearly doubled the number of women corporate vice presidents at Microsoft – both overall and in technical roles. We've increased African American/Black and Hispanic/Latino representation by 33 percent. And this past fiscal year more than half of our U.S. interns were women or African American/Black and Hispanic/Latino. We must keep pushing to do more, and representation is only one measure of progress. Creating a diverse and inclusive workplace at Microsoft is everyone's job. And this year we increased our commitment, ensuring that every leader and employee prioritizes diversity and inclusion as part of our annual performance review process.

In closing, we will continue to create local opportunity, growth and impact in every community and country around the world. We will continue to invest in the largest growth opportunities and innovate boldly to serve our customers. We will continue to help our customers build digital capability, so they can grow and thrive – today and long into the future. We will continue to work to instill trust in technology across everything we do, to advocate for customer privacy, drive industry-wide cybersecurity initiatives and champion ethical AI. And we will continue to transform our culture to reflect the diverse customers we serve around the world, while holding fast to our timeless values.

Last spring, I visited our AI School in Paris, France, which we started earlier this year to provide immersive training to help close the skills gap. Students from different backgrounds and walks of life, with no prior technical experience, are learning new data science skills. They take an intense seven month class, followed by an apprenticeship at one of our local partners – and are ready for new careers in AI and data science. While there, I met Cassandra Delage, a young entrepreneur with an ambitious dream of reimagining recycling. Her company, Plast'if, has created what might be best described as a "recycling vending machine." You take plastic, put it in the machine, and it's converted into a useful object you can take with you. She built it with students at the AI School, creating an ML model that recognizes the plastic, deploying it on an inexpensive computer and then integrating it with a 3-D printer – turning her novel idea into reality.

It's just one example of how technology can help create new opportunity and build a better future for everyone.

And it's just the start – I could not be more optimistic about what's yet to come.

Satya Nadella
Chief Executive Officer
October 16, 2018

FINANCIAL HIGHLIGHTS

(In millions, except per share data)

Year Ended June 30,	**2018**	**2017 [b][c]**	**2016 [b]**	**2015**	**2014 [h]**
Revenue	**$ 110,360**	$ 96,571	$ 91,154	$ 93,580	$ 86,833
Gross margin	**72,007**	62,310	58,374	60,542	59,755
Operating income	**35,058**	29,025 [d]	26,078 [e]	18,161 [g]	27,759
Net income	**16,571 [a]**	25,489 [d]	20,539 [e]	12,193 [g]	22,074
Diluted earnings per share	**2.13 [a]**	3.25 [d]	2.56 [e]	1.48 [g]	2.63
Cash dividends declared per share	**1.68**	1.56	1.44	1.24	1.12
Cash, cash equivalents, and short-term investments	**133,768**	132,981	113,240	96,526	85,709
Total assets	**258,848**	250,312	202,897 [f]	174,303 [f]	170,569 [f]
Long-term obligations	**117,642**	106,856	66,705 [f]	44,574 [f]	35,285 [f]
Stockholders' equity	**82,718**	87,711	83,090	80,083	89,784

(a) *Includes a $13.7 billion net charge related to the Tax Cuts and Jobs Act, which decreased net income and diluted earnings per share ("EPS") by $13.7 billion and $1.75, respectively. Refer to Note 13 – Income Taxes of the Notes to Financial Statements.*

(b) *Reflects the impact of the adoption of new accounting standards in fiscal year 2018 related to revenue recognition and leases. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements.*

(c) *On December 8, 2016, we acquired LinkedIn Corporation. LinkedIn has been included in our consolidated results of operations starting on the acquisition date*.

(d) *Includes $306 million of employee severance expenses primarily related to our sales and marketing restructuring plan, which decreased operating income, net income, and diluted EPS by $306 million, $243 million, and $0.04, respectively.*

(e) *Includes $630 million of asset impairment charges related to our Phone business, and $480 million of restructuring charges associated with our Phone business restructuring plans, which together decreased operating income, net income, and diluted EPS by $1.1 billion, $895 million, and $0.11, respectively.*

(f) *Reflects the impact of the adoption of the new accounting standard in fiscal year 2017 related to balance sheet classification of debt issuance costs.*

(g) *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 business restructuring plans, which together decreased operating income, net income, and diluted EPS by $10.0 billion, $9.5 billion, and $1.15, respectively.*

(h) *On April 25, 2014, we acquired substantially all of Nokia Corporation's Devices and Services business ("NDS"). NDS has been included in our consolidated results of operations starting on the acquisition date.*

QUARTERLY STOCK PRICE INFORMATION, ISSUER PURCHASES OF EQUITY SECURITIES, DIVIDENDS, AND STOCK PERFORMANCE

QUARTERLY STOCK PRICE INFORMATION

Our common stock is traded on the NASDAQ Stock Market under the symbol MSFT. On July 31, 2018, there were 97,535 registered holders of record of our common stock. The high and low common stock sales prices per share were as follows:

Quarter Ended	**September 30**	**December 31**	**March 31**	**June 30**	**Fiscal Year**
Fiscal Year 2018					
High	**$ 75.97**	**$ 87.50**	**$ 97.24**	**$ 102.69**	**$ 102.69**
Low	**68.02**	**73.71**	**83.83**	**87.51**	**68.02**
Fiscal Year 2017					
High	$ 58.70	$ 64.10	$ 66.19	$ 72.89	$ 72.89
Low	50.39	56.32	61.95	64.85	50.39

SHARE REPURCHASES AND DIVIDENDS

Share Repurchases

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to $40.0 billion in share repurchases. This share repurchase program became effective on October 1, 2013, and was completed on December 22, 2016.

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing up to an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of June 30, 2018, $28.2 billion remained of this $40.0 billion share repurchase program.

We repurchased the following shares of common stock under the share repurchase programs:

(In millions)	Shares	Amount	Shares	Amount	Shares	Amount
Year Ended June 30,	2018		2017		2016	
First Quarter	**22**	**$ 1,600**	63	$ 3,550	89	$ 4,000
Second Quarter	**22**	**1,800**	59	3,533	66	3,600
Third Quarter	**34**	**3,100**	25	1,600	69	3,600
Fourth Quarter	**21**	**2,100**	23	1,600	70	3,600
Total	**99**	**$ 8,600**	170	$ 10,283	294	$ 14,800

Shares repurchased beginning in the third quarter of fiscal year 2017 were under the share repurchase program approved September 20, 2016. All other shares repurchased were under the share repurchase program approved September 16, 2013. The above table excludes shares repurchased to settle employee tax withholding related to the vesting of stock awards. All repurchases were made using cash resources.

Dividends

Our Board of Directors declared the following dividends:

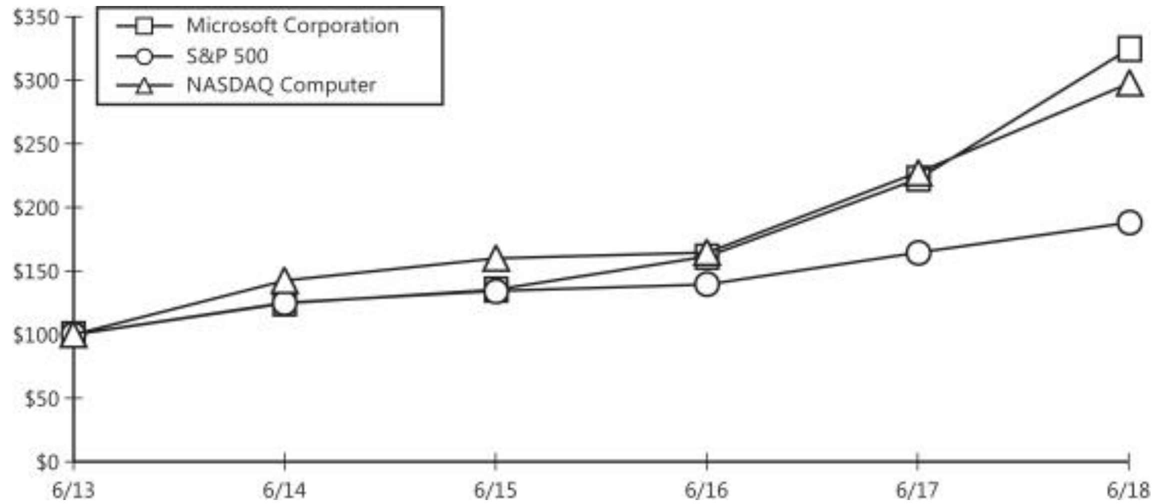
Declaration Date	Dividend Per Share	Record Date	Amount	Payment Date
Fiscal Year 2018			(in millions)	
September 19, 2017	**$ 0.42**	**November 16, 2017**	**$ 3,238**	**December 14, 2017**
November 29, 2017	**0.42**	**February 15, 2018**	**3,232**	**March 8, 2018**
March 12, 2018	**0.42**	**May 17, 2018**	**3,226**	**June 14, 2018**
June 13, 2018	**0.42**	**August 16, 2018**	**3,224**	**September 13, 2018**
Fiscal Year 2017				
September 20, 2016	$ 0.39	November 17, 2016	$ 3,024	December 8, 2016
November 30, 2016	0.39	February 16, 2017	3,012	March 9, 2017
March 14, 2017	0.39	May 18, 2017	3,009	June 8, 2017
June 13, 2017	0.39	August 17, 2017	3,003	September 14, 2017

The dividend declared on June 13, 2018 was included in other current liabilities as of June 30, 2018.

STOCK PERFORMANCE

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Microsoft Corporation, the S&P 500 Index
and the NASDAQ Computer Index



	6/13	6/14	6/15	6/16	6/17	6/18
Microsoft Corporation	**100.00**	**124.27**	**135.05**	**160.88**	**222.08**	**323.90**
S&P 500	**100.00**	**124.61**	**133.86**	**139.20**	**164.11**	**187.70**
NASDAQ Computer	**100.00**	**142.33**	**159.76**	**164.39**	**226.91**	**297.24**

* $100 invested on 6/30/13 in stock or index, including reinvestment of dividends.

Note About Forward-Looking Statements

This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: "Business", and "Management's Discussion and Analysis of Financial Condition and Results of Operations". These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "future," "opportunity," "plan," "may," "should," "will," "would," "will be," "will continue," "will likely result," and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and "Quantitative and Qualitative Disclosures about Market Risk" in our fiscal year 2018 Form 10-K. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date they are made. We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

BUSINESS

GENERAL

Embracing Our Future

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

We continue to transform our business to lead in the new era of the intelligent cloud and intelligent edge. We bring technology and products together into experiences and solutions that unlock value for our customers. In this next phase of innovation, computing is more powerful and ubiquitous from the cloud to the edge. Artificial intelligence ("AI") capabilities are rapidly advancing, fueled by data and knowledge of the world. Physical and virtual worlds are coming together to create richer experiences that understand the context surrounding people, the things they use, the places they go, and their activities and relationships. A person's experience with technology spans a multitude of devices and has become increasingly more natural and multi-sensory with voice, ink, and gaze interactions.

What We Offer

Founded in 1975, we develop and support software, services, devices, and solutions that deliver new value for customers and help people and businesses realize their full potential.

Our products include operating systems; cross-device productivity applications; server applications; business solution applications; desktop and server management tools; software development tools; and video games. We also design, manufacture, and sell devices, including PCs, tablets, gaming and entertainment consoles, other intelligent devices, and related accessories.

We offer an array of services, including cloud-based solutions that provide customers with software, services, platforms, and content, and we provide solution support and consulting services. We also deliver relevant online advertising to a global audience.

The Ambitions That Drive Us

To achieve our vision, our research and development efforts focus on three interconnected ambitions:

- Reinvent productivity and business processes.
- Build the intelligent cloud platform.
- Create more personal computing.

Reinvent Productivity and Business Processes

We are in a unique position to empower people and organizations to succeed in a rapidly evolving workplace. Computing experiences are evolving, no longer bound to one device at a time. Instead, experiences are expanding to many devices as people move from home to work to on the go. These modern needs, habits, and expectations of our customers are motivating us to bring Microsoft Office 365, Windows platform, devices, including Microsoft Surface, and third-party applications into a more cohesive Microsoft 365 experience.

Our growth depends on securely delivering continuous innovation and advancing our leading productivity and collaboration tools and services, including Office, Microsoft Dynamics, and LinkedIn. Microsoft 365 brings together Office 365, Windows 10, and Enterprise Mobility + Security to help organizations empower their employees with AI-backed tools that unlock creativity, increase teamwork, and fuel innovation, all the while enabling compliance coverage and data protection. Microsoft Teams is core to our vision for the modern workplace as the digital hub that creates a single canvas for teamwork, conversations, meetings, and content. Microsoft Relationship Sales solution brings together LinkedIn Sales Navigator and Dynamics to transform business to business sales through social selling. Dynamics 365 for Talent with LinkedIn Recruiter and Learning gives human resource professionals a complete solution to compete for talent.

These scenarios represent a move to unlock creativity and inspire teamwork, while simplifying security and management. Organizations of all sizes can now digitize business-critical functions, redefining what customers can expect from their business applications. This creates an opportunity for us to reach new customers and increase usage and engagement with existing customers.

Build the Intelligent Cloud Platform

Companies are looking to use digital technology to fundamentally reimagine how they empower their employees, engage customers, optimize their operations, and change the very core of their products and services. Partnering with organizations on their digital transformation is one of our largest opportunities and we are uniquely positioned to become the strategic digital transformation platform and partner of choice.

Our strategy requires continued investment in datacenters and other infrastructure to support our services. Microsoft Azure is a trusted cloud with comprehensive compliance coverage and AI-based security built in.

Our cloud business benefits from three economies of scale: datacenters that deploy computational resources at significantly lower cost per unit than smaller ones; datacenters that coordinate and aggregate diverse customer, geographic, and application demand patterns, improving the utilization of computing, storage, and network resources; and multi-tenancy locations that lower application maintenance labor costs.

As one of the two largest providers of cloud computing at scale, we believe we work from a position of strength. Being a global, hyper-scale cloud, Azure uniquely offers hybrid consistency, developer productivity, AI capabilities, and trusted security and compliance. Moreover, with Azure Stack, organizations can extend Azure into their own datacenters to create a consistent stack across the public cloud and the intelligent edge. Our hybrid infrastructure consistency spans identity, data, compute, management, and security, helping to support the real-world needs and evolving regulatory requirements of commercial customers and enterprises.

The ability to convert data into AI drives our competitive advantage. Azure SQL Database makes it possible for customers to take Microsoft SQL Server from their on-premises datacenter to a fully managed instance in the cloud to utilize built-in AI. We are accelerating adoption of AI innovations from research to products. Our innovation helps every developer be an AI developer, with approachable new tools from Azure Machine Learning Studio for creating simple machine learning models, to the powerful Azure Machine Learning Workbench for the most advanced AI modeling and data science.

On June 4, 2018, Microsoft announced plans to acquire GitHub, Inc., a service that millions of developers around the world rely on to write code together. The acquisition is expected to close by the end of the calendar year.

Create More Personal Computing

We strive to make computing more personal by putting users at the core of the experience, enabling them to interact with technology in more intuitive, engaging, and dynamic ways. Windows 10 is the cornerstone of our ambition, providing a foundation for the secure, modern workplace, and designed to foster innovation through rich and consistent experiences across the range of existing devices and entirely new device categories. Windows 10 empowers people with AI-first interfaces ranging from voice-activated commands through Cortana, inking, immersive 3D content storytelling, and mixed reality experiences. Cloud sharing and co-authoring experiences are now natively enabled with OneDrive files on demand. Windows 10 is more accessible for everyone with new features like Eye Control, which gives people the ability to operate a PC using just their eyes.

Our ambition for Windows 10 is to broaden our economic opportunity through three key levers: an original equipment manufacturer (“OEM”) ecosystem that creates exciting new hardware designs for Windows 10; our commitment to our first-party premium device portfolio; and monetization opportunities such as gaming, services, subscriptions, and search advertising.

We are working to create a broad developer opportunity by unifying the Windows installed base on Windows 10 and enabling universal Windows applications to run across devices so developers and OEMs can contribute to a thriving Windows ecosystem. Additionally, we are committed to designing and marketing first-party devices, such as the Surface Laptop, Surface Book 2, and Surface Pro to help drive innovation, create new device categories, and stimulate demand in the Windows ecosystem.

We are mobilizing to pursue our expansive opportunity in the gaming industry, broadening our approach to how we think about gaming end-to-end, from the way games are created and distributed to how they are played and viewed. We have a strong position with our Xbox One console, our large and growing highly engaged community of gamers on Xbox Live, and with Windows 10, the most popular operating system for PC gamers. And we will continue to connect our gaming assets across PC, console, and mobile, and work to grow and engage the Xbox Live member network more deeply and frequently with new services like Mixer and Xbox Game Pass. Our approach is to enable gamers to play the games they want, with the people they want, on the devices they want.

Our Future Opportunity

Customers are looking to us to accelerate their own digital transformations and to unlock new opportunity in this era of intelligent cloud and intelligent edge. We continue to develop complete, intelligent solutions for our customers that empower users to be creative and work together while safeguarding businesses and simplifying IT management. Our goal is to lead the industry in several distinct areas of technology over the long-term, which we expect will translate to sustained growth. We are investing significant resources in:

- Transforming the workplace to deliver new modern, modular business applications to improve how people communicate, collaborate, learn, work, play, and interact with one another.
- Building and running cloud-based services in ways that unleash new experiences and opportunities for businesses and individuals.
- Applying AI to drive insights and act on our customer’s behalf by understanding and interpreting their needs using natural methods of communication.

- Using Windows to develop new categories of devices – both our own and third-party – as a person's experience with technology becomes more natural, personal, and predictive with multi-sensory breakthroughs in voice, ink, gaze interactions, and augmented reality holograms.
- Inventing new gaming experiences that bring people together around their shared love for games on any devices and pushing the boundaries of innovation with console and PC gaming by creating the next wave of entertainment.

Our future growth depends on our ability to transcend current product category definitions, business models, and sales motions. We have the opportunity to redefine what customers and partners can expect and are working to deliver new solutions that reflect the best of Microsoft.

OPERATING SEGMENTS

We operate our business and report our financial performance using three segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. Our segments provide management with a comprehensive financial view of our key businesses. The segments enable the alignment of strategies and objectives across the development, sales, marketing, and services organizations, and they provide a framework for timely and rational allocation of resources within businesses.

Additional information on our operating segments and geographic and product information is contained in Note 21 – Segment Information and Geographic Data of the Notes to Financial Statements.

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 Office 365 subscriptions and Office licensed on-premises, comprising Office, Exchange, SharePoint, Skype for Business, and Microsoft Teams, and related Client Access Licenses ("CALs").
- Office Consumer, including Office 365 subscriptions and Office licensed on-premises, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.
- LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.
- Dynamics business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.

Office Commercial

Office Commercial is designed to increase personal, team, and organizational productivity through a range of products and services. Growth depends on our ability to reach new users in new markets such as first-line workers, small and medium businesses, and growth markets, as well as add value to our core product and service offerings to span productivity categories such as communication, collaboration, analytics, and security. Office Commercial revenue is mainly affected by a combination of continued installed base growth and average revenue per user expansion, as well as the continued shift from Office licensed on-premises to Office 365. CALs provide certain Office Commercial products and services with access rights to our server products and CAL revenue is reported with the associated Office products and services.

Office Consumer

Office Consumer is designed to increase personal productivity through a range of products and services. Growth depends on our ability to reach new users, add value to our core product set, and continue to expand our product and service offerings into new markets. Office Consumer revenue is mainly affected by the percentage of customers that buy Office with their new devices and the continued shift from Office licensed on-premises to Office 365. Office Consumer Services revenue is mainly affected by the demand for communication and storage through Skype, Outlook.com, and OneDrive, which is largely driven by subscriptions, advertising, and the sale of minutes.

LinkedIn

LinkedIn connects the world's professionals to make them more productive and successful, and is the world's largest professional network on the Internet. LinkedIn offers services that can be used by customers to transform the way they hire, market, sell, and learn. In addition to LinkedIn's free services, LinkedIn offers three categories of monetized solutions: Talent Solutions, Marketing Solutions, and Premium Subscriptions, which includes Sales Solutions. Talent Solutions is comprised of two elements: Hiring, and Learning and Development. Hiring provides services to recruiters that enable them to attract, recruit, and hire talent. Learning and Development provides subscriptions to enterprises and individuals to access online learning content. Marketing Solutions enables companies to advertise to LinkedIn's member base. Premium Subscriptions enables professionals to manage their professional identity, grow their network, and connect with talent through additional services like premium search. Premium Subscriptions also includes Sales Solutions, which helps sales professionals find, qualify, and create sales opportunities and accelerate social selling capabilities. Growth will depend on our ability to increase the number of LinkedIn members and our ability to continue offering services that provide value for our members and increase their engagement. LinkedIn revenue is mainly affected by demand from enterprises and professional organizations for subscriptions to Talent Solutions and Premium Subscriptions offerings, as well as member engagement and the quality of the sponsored content delivered to those members to drive Marketing Solutions.

Dynamics

Dynamics provides on-premises and cloud-based business solutions for financial management, enterprise resource planning ("ERP"), customer relationship management ("CRM"), supply chain management, and analytics applications for small and medium businesses, large organizations, and divisions of global enterprises. Dynamics revenue is largely driven by the number of users licensed and the continued shift to Dynamics 365, a unified set of cloud-based intelligent business applications.

<u>Competition</u>

Competitors to Office include software and global application vendors, such as Apple, Cisco Systems, Facebook, Google, IBM, and Slack, and numerous web-based and mobile application competitors as well as local application developers. Apple distributes versions of its pre-installed application software, such as email and calendar products, through its PCs, tablets, and phones. Cisco Systems is using its position in enterprise communications equipment to grow its unified communications business. Google provides a hosted messaging and productivity suite. Skype for Business and Skype also compete with a variety of instant messaging, voice, and video communication providers, ranging from start-ups to established enterprises. Web-based offerings competing with individual applications have also positioned themselves as alternatives to our products and services. We compete by providing powerful, flexible, secure, and easy-to-use productivity and collaboration tools and services that create comprehensive solutions and work well with technologies our customers already have both on-premises or in the cloud.

LinkedIn faces competition from online recruiting companies, talent management companies, and larger companies that are focusing on talent management and human resource services; job boards; traditional recruiting firms; and companies that provide learning and development products and services. Marketing Solutions competes with online and offline outlets that generate revenue from advertisers and marketers.

Dynamics competes with vendors such as Infor, Oracle, NetSuite. Salesforce.com, SAP, and The Sage Group to provide on-premise and cloud-based business solutions for small, medium, and large organizations.

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

Server Products and Cloud Services

Our server products are designed to make IT professionals, developers, and their systems more productive and efficient. Server software is integrated server infrastructure and middleware designed to support software applications built on the Windows Server operating system. This includes the server platform, database, business intelligence, storage, management and operations, virtualization, service-oriented architecture platform, security, and identity software. We also license standalone and software development lifecycle tools for software architects, developers, testers, and project managers. Server products revenue is mainly affected by purchases through volume licensing programs, licenses sold to OEMs, and retail packaged products. CALs provide access rights to certain server products, including SQL Server and Windows Server, and revenue is reported along with the associated server product.

Azure is a comprehensive set of cloud services that offer developers, IT professionals, and enterprises freedom to build, deploy, and manage applications on any platform or device. Customers can use Azure through our global network of datacenters for basic computing, networking, storage, mobile and web app services, AI, Internet of Things ("IoT"), cognitive services, and machine learning. Azure enables customers to devote more resources to development and use of applications that benefit their organizations, rather than managing on-premises hardware and software. Azure revenue is mainly affected by infrastructure-as-a-service and platform-as-a-service consumption-based services, and per user-based services such as Enterprise Mobility + Security.

Enterprise Services

Enterprise Services, including Premier Support Services and Microsoft Consulting Services, assist customers in developing, deploying, and managing Microsoft server and desktop solutions and provide training and certification to developers and IT professionals on various Microsoft products.

Competition

Our server products face competition from a wide variety of server operating systems and applications offered by companies with a range of market approaches. Vertically integrated computer manufacturers such as Hewlett-Packard, IBM, and Oracle offer their own versions of the Unix operating system preinstalled on server hardware. Nearly all computer manufacturers offer server hardware for the Linux operating system and many contribute to Linux operating system development. The competitive position of Linux has also benefited from the large number of compatible applications now produced by many commercial and non-commercial software developers. A number of companies, such as Red Hat, supply versions of Linux.

We compete to provide enterprise-wide computing solutions and point solutions with numerous commercial software vendors that offer solutions and middleware technology platforms, software applications for connectivity (both Internet and intranet), security, hosting, database, and e-business servers. IBM and Oracle lead a group of companies focused on the Java Platform Enterprise Edition that competes with our enterprise-wide computing solutions. Commercial competitors for our server applications for PC-based distributed client-server environments include CA Technologies, IBM, and Oracle. Our web application platform software competes with open source software such as Apache, Linux, MySQL, and PHP. In middleware, we compete against Java vendors.

Our database, business intelligence, and data warehousing solutions offerings compete with products from IBM, Oracle, SAP, and other companies. Our system management solutions compete with server management and server virtualization platform providers, such as BMC, CA Technologies, Hewlett-Packard, IBM, and VMware. Our products for software developers compete against offerings from Adobe, IBM, Oracle, and other companies, and also against open-source projects, including Eclipse (sponsored by CA Technologies, IBM, Oracle, and SAP), PHP, and Ruby on Rails.

We believe our server products provide customers with advantages in performance, total costs of ownership, and productivity by delivering superior applications, development tools, compatibility with a broad base of hardware and software applications, security, and manageability.

Azure faces diverse competition from companies such as Amazon, Google, IBM, Oracle, Salesforce.com, VMware, and open source offerings. Azure's competitive advantage includes enabling a hybrid cloud, allowing deployment of existing datacenters with our public cloud into a single, cohesive infrastructure, and the ability to run at a scale that meets the needs of businesses of all sizes and complexities.

Our Enterprise Services business competes with a wide range of companies that provide strategy and business planning, application development, and infrastructure services, including multinational consulting firms and small niche businesses focused on specific technologies.

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 all devices. This segment primarily comprises:

- Windows, including Windows OEM licensing ("Windows OEM") and other non-volume licensing of the Windows operating system; Windows Commercial, comprising volume licensing of the Windows operating system, Windows cloud services, and other Windows commercial offerings; patent licensing; Windows IoT; and MSN advertising.
- Devices, including Surface, PC accessories, and other intelligent devices.
- Gaming, including Xbox hardware and Xbox software and services, comprising Xbox Live transactions, subscriptions, and advertising ("Xbox Live"), video games, and third-party video game royalties.
- Search.

Windows

The Windows operating system is designed to deliver a more personal computing experience for users by enabling consistency of experience, applications, and information across their devices. Windows OEM revenue is impacted significantly by the number of Windows operating system licenses purchased by OEMs, which they pre-install on the devices they sell. In addition to computing device market volume, Windows OEM revenue is impacted by:

- The mix of computing devices based on form factor and screen size.
- Differences in device market demand between developed markets and growth markets.
- Attachment of Windows to devices shipped.
- Customer mix between consumer, small and medium businesses, and large enterprises.
- Changes in inventory levels in the OEM channel.

- Pricing changes and promotions, pricing variation that occurs when the mix of devices manufactured shifts from local and regional system builders to large multinational OEMs, and different pricing of Windows versions licensed.
- Piracy.

Windows Commercial revenue, which includes volume licensing of the Windows operating system and Windows cloud services such as Windows Defender Advanced Threat Protection, is affected mainly by the demand from commercial customers for volume licensing and Software Assurance (“SA”), as well as advanced security offerings. Windows Commercial revenue often reflects the number of information workers in a licensed enterprise and is relatively independent of the number of PCs sold in a given year.

Patent licensing includes our programs to license patents we own for use across a broad array of technology areas, including mobile devices and cloud offerings.

Windows IoT extends the power of Windows and the cloud to intelligent systems by delivering specialized operating systems, tools, and services for use in embedded devices.

MSN advertising includes both native and display ads.

Devices

We design, manufacture, and sell devices, including Surface, PC accessories, and other intelligent devices, such as Surface Hub and HoloLens. Our devices are designed to enable people and organizations to connect to the people and content that matter most using Windows and integrated Microsoft products and services. Surface is designed to help organizations, students, and consumers be more productive.

In May 2016, we announced plans to streamline our smartphone hardware business. In November 2016, we completed the sale of our feature Phone business.

Gaming

Our gaming platform is designed to provide a unique variety of entertainment using our devices, peripherals, applications, online services, and content. We released Xbox One S and Xbox One X in August 2016 and November 2017, respectively. With the launch of the Mixer service in May 2017, offering interactive live game streaming, and Xbox Game Pass in June 2017, providing unlimited access to over 100 Xbox titles, we continue to open new opportunities for customers to engage both on- and off-console.

Xbox Live enables people to connect and share online gaming experiences and is accessible on Xbox consoles, Windows-enabled devices, and other devices. Xbox Live is designed to benefit users by providing access to a network of certified applications and services and to benefit our developer and partner ecosystems by providing access to a large customer base. Xbox Live revenue is mainly affected by subscriptions and sales of Xbox Live enabled content, as well as advertising. We also continue to design and sell gaming content to showcase our unique platform capabilities for Xbox consoles, Windows-enabled devices, and other devices. Growth of our Gaming business is determined by the overall active user base through Xbox Live enabled content, availability of games, providing exclusive game content that gamers seek, the computational power and reliability of the devices used to access our content and services, and the ability to create new experiences via online services, downloadable content, and peripherals.

Search

Our Search business, including Bing and Bing Ads, is designed to deliver relevant online advertising to a global audience. We have several partnerships with other companies, including Oath (formerly Yahoo! and AOL) which is owned by Verizon, through which we provide and monetize search queries. Growth depends on our ability to attract new users, understand intent, and match intent with relevant content and advertiser offerings.

Competition

Windows faces competition from various software products and from alternative platforms and devices, mainly from Apple and Google. We believe Windows competes effectively by giving customers choice, value, flexibility, security, an easy-to-use interface, and compatibility with a broad range of hardware and software applications, including those that enable productivity.

Devices face competition from various computer, tablet, and hardware manufacturers who offer a unique combination of high-quality industrial design and innovative technologies across various price points. These manufacturers, many of which are also current or potential partners and customers, include Apple and our Windows OEMs.

Our gaming platform competes with console platforms from Nintendo and Sony, both of which have a large, established base of customers. The lifecycle for gaming and entertainment consoles averages five to ten years. Nintendo released its latest generation console in March 2017 and Sony released its latest generation console in November 2013. We also compete with other providers of entertainment services through online marketplaces. We believe our gaming platform is effectively positioned against competitive products and services based on significant innovation in hardware architecture, user interface, developer tools, online gaming and entertainment services, and continued strong exclusive content from our own game franchises as well as other digital content offerings. Our video games competitors include Electronic Arts and Activision Blizzard. Xbox Live faces competition from various online marketplaces, including those operated by Amazon, Apple, and Google.

Our search business competes with Google and a wide array of websites, social platforms like Facebook, and portals that provide content and online offerings to end users.

OPERATIONS

We have operations centers that support operations in their regions, including customer contract and order processing, credit and collections, information processing, and vendor management and logistics. The regional center in Ireland supports the European, Middle Eastern, and African region; the center in Singapore supports the Japan, India, Greater China, and Asia-Pacific region; and the centers in Fargo, North Dakota, Fort Lauderdale, Florida, Puerto Rico, Redmond, Washington, and Reno, Nevada support Latin America and North America. In addition to the operations centers, we also operate datacenters throughout the Americas, Australia, Europe, and Asia.

To serve the needs of customers around the world and to improve the quality and usability of products in international markets, we localize many of our products to reflect local languages and conventions. Localizing a product may require modifying the user interface, altering dialog boxes, and translating text.

Our devices are primarily manufactured by third-party contract manufacturers. We generally have the ability to use other manufacturers if a current vendor becomes unavailable or unable to meet our requirements.

RESEARCH AND DEVELOPMENT

During fiscal years 2018, 2017, and 2016, research and development expense was $14.7 billion, $13.0 billion, and $12.0 billion, respectively. These amounts represented 13% of revenue in fiscal years 2018, 2017, and 2016. We plan to continue to make significant investments in a broad range of research and development efforts.

Product and Service Development, and Intellectual Property

We develop most of our products and services internally through the following engineering groups.

- *Cloud and AI Platform*, focuses on making IT professionals, developers, and their systems more productive and efficient through development of cloud infrastructure, server, database, CRM, ERP, management and development tools, AI cognitive services, and other business process applications and services for enterprises.

- *Experiences and Devices*, focuses on instilling a unifying product ethos across our end-user experiences and devices, including Office, Windows, Enterprise Mobility and Management, and devices.
- *AI and Research*, focuses on our AI innovations and other forward-looking research and development efforts spanning infrastructure, services, applications, and search.
- *LinkedIn*, focuses on our services that transform the way customers hire, market, sell, and learn.
- *Gaming*, focuses on connecting gaming assets across the range of devices to grow and engage the Xbox Live member network through game experiences, streaming content, and social interaction.

Internal development allows us to maintain competitive advantages that come from product differentiation and closer technical control over our products and services. It also gives us the freedom to decide which modifications and enhancements are most important and when they should be implemented. We strive to obtain information as early as possible about changing usage patterns and hardware advances that may affect software and hardware design. Before releasing new software platforms, and as we make significant modifications to existing platforms, we provide application vendors with a range of resources and guidelines for development, training, and testing. Generally, we also create product documentation internally.

We protect our intellectual property investments in a variety of ways. We work actively in the U.S. and internationally to ensure the enforcement of copyright, trademark, trade secret, and other protections that apply to our software and hardware products, services, business plans, and branding. We are a leader among technology companies in pursuing patents and currently have a portfolio of over 53,000 U.S. and international patents issued and over 29,000 pending. While we employ much of our internally developed intellectual property exclusively in our products and services, we also engage in outbound licensing of specific patented technologies that are incorporated into licensees' products. From time to time, we enter into broader cross-license agreements with other technology companies covering entire groups of patents. We also purchase or license technology that we incorporate into our products and services. At times, we make select intellectual property broadly available at no or low cost to achieve a strategic objective, such as promoting industry standards, advancing interoperability, or attracting and enabling our external development community. Our increasing engagement with open source software will also cause us to license our intellectual property rights broadly in certain situations.

While it may be necessary in the future to seek or renew licenses relating to various aspects of our products, services, and business methods, we believe, based upon past experience and industry practice, such licenses generally can be obtained on commercially reasonable terms. We believe our continuing research and product development are not materially dependent on any single license or other agreement with a third party relating to the development of our products.

Investing in the Future

Our success is based on our ability to create new and compelling products, services, and experiences for our users, to initiate and embrace disruptive technology trends, to enter new geographic and product markets, and to drive broad adoption of our products and services. We invest in a range of emerging technology trends and breakthroughs that we believe offer significant opportunities to deliver value to our customers and growth for the company. Based on our assessment of key technology trends, we maintain our long-term commitment to research and development across a wide spectrum of technologies, tools, and platforms spanning digital work and life experiences, cloud computing, AI, devices, and operating systems.

While our main research and development facilities are located in Redmond, Washington, we also operate research and development facilities in other parts of the U.S. and around the world, including Canada, China, India, Ireland, Israel, and the United Kingdom. This global approach helps us remain competitive in local markets and enables us to continue to attract top talent from across the world. We generally fund research at the corporate level to ensure that we are looking beyond immediate product considerations to opportunities further in the future. We also fund research and development activities at the operating segment level. Much of our segment level research and development is coordinated with other segments and leveraged across the company.

In addition to our main research and development operations, we also operate Microsoft Research. Microsoft Research is one of the world's largest corporate research organizations and works in close collaboration with top universities around the world to advance the state-of-the-art in computer science and a broad range of other disciplines, providing us a unique perspective on future trends and contributing to our innovation.

DISTRIBUTION, SALES, AND MARKETING

We market and distribute our products and services through the following channels: OEMs, direct, and distributors and resellers. Our sales force performs a variety of functions, including working directly with enterprises and public-sector organizations worldwide to identify and meet their technology requirements; managing OEM relationships; and supporting system integrators, independent software vendors, and other partners who engage directly with our customers to perform sales, consulting, and fulfillment functions for our products and services.

OEMs

We distribute our products and services through OEMs that pre-install our software on new devices and servers they sell. The largest component of the OEM business is the Windows operating system pre-installed on devices. OEMs also sell devices pre-installed with other Microsoft products and services, including applications such as Office and the capability to subscribe to Office 365.

There are two broad categories of OEMs. The largest category of OEMs are direct OEMs as our relationship with them is managed through a direct agreement between Microsoft and the OEM. We have distribution agreements covering one or more of our products with virtually all the multinational OEMs, including Acer, ASUS, Dell, Fujitsu, Hewlett-Packard, Lenovo, Samsung, Toshiba, and with many regional and local OEMs. The second broad category of OEMs are system builders consisting of lower-volume PC manufacturers, which source Microsoft software for pre-installation and local redistribution primarily through the Microsoft distributor channel rather than through a direct agreement or relationship with Microsoft.

Direct

Many organizations that license our products and services transact directly with us through Enterprise Agreements and Enterprise Services contracts, with sales support from system integrators, independent software vendors, web agencies, and partners that advise organizations on licensing our products and services ("Enterprise Agreement Software Advisors", or "ESA"). Microsoft offers direct sales programs targeted to reach small, medium, and corporate customers, in addition to those offered through the reseller channel. A large network of partner advisors support many of these sales.

We also sell commercial and consumer products and services directly to customers, such as cloud services, search, and gaming, through our digital marketplaces, online stores, and retail stores.

Distributors and Resellers

Organizations also license our products and services indirectly, primarily through licensing solution partners ("LSP"), distributors, value-added resellers ("VAR"), and retailers. Although each type of reselling partner may reach organizations of all sizes, LSPs are primarily engaged with large organizations, distributors resell primarily to VARs, and VARs typically reach small and medium organizations. ESAs are also typically authorized as LSPs and operate as resellers for our other volume licensing programs. Microsoft Cloud Solution Provider is our main partner program for reselling cloud services.

We distribute our retail packaged products primarily through independent non-exclusive distributors, authorized replicators, resellers, and retail outlets. Individual consumers obtain these products primarily through retail outlets. We distribute our devices through third-party retailers. We have a network of field sales representatives and field support personnel that solicit orders from distributors and resellers, and provide product training and sales support.

Our Dynamics business solutions are also licensed to enterprises through a global network of channel partners providing vertical solutions and specialized services.

LICENSING OPTIONS

We offer options for organizations that want to purchase our cloud services, on-premises software, and Software Assurance. We license software to organizations under volume licensing agreements to allow the customer to acquire multiple licenses of products and services instead of having to acquire separate licenses through retail channels. We use different programs designed to provide flexibility for organizations of various sizes. While these programs may differ in various parts of the world, generally they include those discussed below.

SA conveys rights to new software and upgrades for perpetual licenses released over the contract period. It also provides support, tools, and training to help customers deploy and use software efficiently. SA is included with certain volume licensing agreements and is an optional purchase with others.

Volume Licensing Programs

Enterprise Agreement

Enterprise Agreements offer large organizations a manageable volume licensing program that gives them the flexibility to buy cloud services and software licenses under one agreement. Enterprise Agreements are designed for medium or large organizations that want to license cloud services and on-premises software organization-wide over a three-year period. Organizations can elect to purchase perpetual licenses or subscribe to licenses. SA is included.

Microsoft Product and Services Agreement

Microsoft Product and Services Agreements are designed for medium and large organizations that want to license cloud services and on-premises software as needed, with no organization-wide commitment, under a single, non-expiring agreement. Organizations purchase perpetual licenses or subscribe to licenses. SA is optional for customers that purchase perpetual licenses.

Open

Open agreements are a simple, cost-effective way to acquire the latest Microsoft technology. Open agreements are designed for small and medium organizations that want to license cloud services and on-premises software over a one- to three-year period. Under the Open agreements, organizations purchase perpetual licenses and SA is optional. Under Open Value agreements, organizations can elect to purchase perpetual licenses or subscribe to licenses and SA is included.

Select Plus

Select Plus agreements are designed for government and academic organizations to acquire on-premises licenses at any affiliate or department level, while realizing advantages as one organization. Organizations purchase perpetual licenses and SA is optional.

In July 2014, we announced the retirement over a two-year period of Select Plus agreements for commercial organizations. Beginning July 2015, no new Select Plus agreements were signed with commercial organizations.

Microsoft Online Subscription Agreement

Microsoft Online Subscription Agreements are designed for small and medium organizations that want to subscribe to, activate, provision, and maintain cloud services seamlessly and directly via the web. The agreement allows customers to acquire monthly or annual subscriptions for cloud-based services.

Partner Programs

The Microsoft Cloud Solution Provider program offers customers an easy way to license the cloud services they need in combination with the value-added services offered by their systems integrator, hosting partner, or cloud reseller partner. Partners in this program can easily package their own products and services to directly provision, manage, and support their customer subscriptions.

The Microsoft Services Provider License Agreement allows service providers and independent software vendors who want to license eligible Microsoft software products to provide software services and hosted applications to their end customers. Partners license software over a three-year period and are billed monthly based on consumption.

The Independent Software Vendor Royalty program enables partners to integrate Microsoft products into other applications and then license the unified business solution to their end users.

CUSTOMERS

Our customers include individual consumers, small and medium organizations, large global enterprises, public-sector institutions, internet service providers, application developers, and OEMs. No sales to an individual customer accounted for more than 10% of revenue in fiscal years 2018, 2017, or 2016. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

EMPLOYEES

As of June 30, 2018, we employed approximately 131,000 people on a full-time basis, 78,000 in the U.S. and 53,000 internationally. Of the total employed people, 42,000 were in operations, including manufacturing, distribution, product support, and consulting services; 42,000 were in product research and development; 36,000 were in sales and marketing; and 11,000 were in general and administration. Certain of our employees are subject to collective bargaining agreements.

AVAILABLE INFORMATION

Our Internet address is www.microsoft.com. At our Investor Relations website, www.microsoft.com/investor, we make available free of charge a variety of information for investors. Our goal is to maintain the Investor Relations website as a portal through which investors can easily find or navigate to pertinent information about us, including:

- Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission (“SEC”).
- Information on our business strategies, financial results, and metrics for investors.
- Announcements of investor conferences, speeches, and events at which our executives talk about our product, service, and competitive strategies. Archives of these events are also available.
- Press releases on quarterly earnings, product and service announcements, legal developments, and international news.
- Corporate governance information including our articles of incorporation, bylaws, governance guidelines, committee charters, codes of conduct and ethics, global corporate social responsibility initiatives, and other governance-related policies.
- Other news and announcements that we may post from time to time that investors might find useful or interesting.
- Opportunities to sign up for email alerts to have information pushed in real time.

The information found on our website is not part of this or any other report we file with, or furnish to, the SEC. In addition to these channels, we use social media to communicate to the public. It is possible that the information we post on social media could be deemed to be material to investors. We encourage investors, the media, and others interested in Microsoft to review the information we post on the social media channels listed on our Investor Relations website.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying Notes to Financial Statements.

OVERVIEW

Microsoft is a technology company whose mission is to empower every person and every organization on the planet to achieve more. We strive to create local opportunity, growth, and impact in every country around the world. Our platforms and tools help drive small business productivity, large business competitiveness, and public-sector efficiency. They also support new startups, improve educational and health outcomes, and empower human ingenuity.

We generate revenue by licensing and supporting an array of software products; offering a wide range of cloud-based and other services to people and businesses; designing, manufacturing, and selling devices; and delivering relevant online advertising to a global audience. Our most significant expenses are related to compensating employees; designing, manufacturing, marketing, and selling our products and services; datacenter costs in support of our cloud-based services; and income taxes.

Highlights from fiscal year 2018 compared with fiscal year 2017 included:

- Commercial cloud revenue, which primarily comprises Microsoft Office 365 commercial, Microsoft Azure, Microsoft Dynamics 365, and other cloud properties, increased 56% to $23.2 billion.
- Office Commercial revenue increased 11%, driven by Office 365 commercial revenue growth of 41%.
- Office Consumer revenue increased 11% and Office 365 consumer subscribers increased to 31.4 million.
- LinkedIn contributed revenue of $5.3 billion, driven by strong momentum across all business lines.
- Dynamics revenue increased 13%, driven by Dynamics 365 revenue growth of 65%.
- Server products and cloud services revenue increased 21%, driven by Azure revenue growth of 91%.
- Enterprise Services revenue increased 5%.
- Windows original equipment manufacturer licensing ("Windows OEM") revenue increased 5%, driven by OEM Pro revenue growth of 11%.
- Windows Commercial revenue increased 12%, driven by an increased volume of multi-year agreements.
- Gaming revenue increased 14%, driven by Xbox software and services revenue growth of 20%, mainly from third-party title strength.
- Microsoft Surface revenue increased 16%, driven by a higher mix of premium devices and an increase in volumes sold, due to the latest editions of Surface.
- Search advertising revenue, excluding traffic acquisition costs, increased 16%, driven by higher revenue per search and search volume.

On June 4, 2018, we entered into a definitive agreement to acquire GitHub, Inc. for $7.5 billion in an all-stock transaction, which is expected to close by the end of the calendar year. On December 8, 2016, we completed our acquisition of LinkedIn Corporation for a total purchase price of $27.0 billion. LinkedIn has been included in our consolidated results of operations since the date of acquisition. Refer to Note 9 – Business Combinations of the Notes to Financial Statements for further discussion.

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business. During fiscal year 2018, we recorded a net charge of $13.7 billion related to the TCJA. Refer to Note 13 – Income Taxes of the Notes to Financial Statements for further discussion.

We adopted the new accounting standards for revenue recognition and leases effective July 1, 2017. These new standards had a material impact in our consolidated financial statements. Beginning in fiscal year 2018, our financial results reflect adoption of the standards with prior periods restated accordingly. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements for further discussion.

Industry Trends

Our industry is dynamic and highly competitive, with frequent changes in both technologies and business models. Each industry shift is an opportunity to conceive new products, new technologies, or new ideas that can further transform the industry and our business. At Microsoft, we push the boundaries of what is possible through a broad range of research and development activities that seek to identify and address the changing demands of customers and users, industry trends, and competitive forces.

Economic Conditions, Challenges, and Risks

The markets for software, devices, and cloud-based services are dynamic and highly competitive. Our competitors are developing new software and devices, while also deploying competing cloud-based services for consumers and businesses. The devices and form factors customers prefer evolve rapidly, and influence how users access services in the cloud, and in some cases, the user's choice of which suite of cloud-based services to use. We must continue to evolve and adapt over an extended time in pace with this changing environment. The investments we are making in infrastructure and devices will continue to increase our operating costs and may decrease our operating margins.

Our success is highly dependent on our ability to attract and retain qualified employees. We hire a mix of university and industry talent worldwide. We compete for talented individuals globally by offering an exceptional working environment, broad customer reach, scale in resources, the ability to grow one's career across many different products and businesses, and competitive compensation and benefits. Aggregate demand for our software, services, and devices is correlated to global macroeconomic and geopolitical factors, which remain dynamic.

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. Strengthening of the U.S. dollar relative to certain foreign currencies throughout fiscal year 2017 negatively impacted reported revenue and reduced reported expenses from our international operations. This trend reversed in fiscal year 2018. Strengthening of foreign currencies relative to the U.S. dollar positively impacted reported revenue and increased reported expenses from our international operations.

Refer to Risk Factors in our fiscal year 2018 Form 10-K for a discussion of these factors and other risks.

Seasonality

We expect our revenue to fluctuate quarterly and to be higher in the second and fourth quarters of our fiscal year. Second quarter revenue is driven by corporate year-end spending trends in our major markets and holiday season spending by consumers, and fourth quarter revenue is driven by the volume of multi-year on-premises contracts executed during the period.

Reportable Segments

We report our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. The segment amounts included in MD&A are presented on a basis consistent with our internal management reporting. All differences between our internal management reporting basis and accounting principles generally accepted in the United States of America (“GAAP”), along with certain corporate-level and other activity, are included in Corporate and Other.

Additional information on our reportable segments is contained in Note 21 – Segment Information and Geographic Data of the Notes to Financial Statements.

SUMMARY RESULTS OF OPERATIONS

(In millions, except percentages and per share amounts)	2018	2017	2016	Percentage Change 2018 Versus 2017	Percentage Change 2017 Versus 2016
Revenue	**$ 110,360**	$ 96,571	$ 91,154	14%	6%
Gross margin	**72,007**	62,310	58,374	16%	7%
Operating income	**35,058**	29,025	26,078	21%	11%
Net Income	**16,571**	25,489	20,539	(35)%	24%
Diluted earnings per share	**2.13**	3.25	2.56	(34)%	27%
Adjusted operating income	**35,058**	29,331	27,188	20%	8%
Adjusted net income	**30,267**	25,732	21,434	18%	20%
Adjusted diluted earnings per share	**3.88**	3.29	2.67	18%	23%

Consolidated results of operations include LinkedIn results since the date of acquisition on December 8, 2016. Fiscal year 2018 includes a full period of LinkedIn results, whereas fiscal year 2017 only includes results from the date of acquisition.

Adjusted operating income, net income, and adjusted diluted earnings per share (“EPS”) exclude the net charge related to the TCJA, and impairment and restructuring expenses. Refer to the Non-GAAP Financial Measures section below for a reconciliation of our financial results reported in accordance with GAAP to non-GAAP financial results.

Fiscal Year 2018 Compared with Fiscal Year 2017

Revenue increased $13.8 billion or 14%, driven by growth across each of our segments. Productivity and Business Processes revenue increased, driven by LinkedIn and higher revenue from Office. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue increased, driven by higher revenue from Gaming, Windows, Search advertising, and Surface, offset in part by lower revenue from Phone.

Gross margin increased $9.7 billion or 16%, due to growth across each of our segments. Gross margin percentage increased slightly, driven by favorable segment sales mix and gross margin percentage improvement in More Personal Computing. Gross margin included a 7 percentage point improvement in commercial cloud, primarily from Azure.

Operating income increased $6.0 billion or 21%, driven by growth across each of our segments. LinkedIn operating loss increased $63 million to $987 million, including $1.5 billion of amortization of intangible assets. Operating income included a favorable foreign currency impact of 2%.

Key changes in expenses were:

- Cost of revenue increased $4.1 billion or 12%, mainly due to growth in our commercial cloud, Gaming, LinkedIn, and Search advertising, offset in part by a reduction in Phone cost of revenue.
- Sales and marketing expenses increased $2.0 billion or 13%, primarily due to LinkedIn expenses and investments in commercial sales capacity, offset in part by a decrease in Windows marketing expenses.
- Research and development expenses increased $1.7 billion or 13%, primarily due to investments in cloud engineering and LinkedIn expenses.
- General and administrative expenses increased $273 million or 6%, primarily due to LinkedIn expenses.

Current year net income and diluted EPS were negatively impacted by the net charge related to TCJA, which resulted in a decrease to net income and diluted earnings per share of $13.7 billion and $1.75, respectively. Prior year diluted EPS was negatively impacted by restructuring expenses, which resulted in a decrease in operating income, net income, and diluted EPS of $306 million, $243 million, and $0.04, respectively.

Fiscal Year 2017 Compared with Fiscal Year 2016

Revenue increased $5.4 billion or 6%, driven by growth in Productivity and Business Processes and Intelligent Cloud, offset in part by lower revenue from More Personal Computing. Productivity and Business Processes revenue increased, driven by the acquisition of LinkedIn and higher revenue from Microsoft Office. Intelligent Cloud revenue increased, primarily due to higher revenue from server products and cloud services. More Personal Computing revenue decreased, mainly due to lower revenue from Devices, offset in part by higher revenue from Windows and Search advertising.

Gross margin increased $3.9 billion or 7%, due to growth across each of our segments, including the acquisition of LinkedIn, driven by higher revenue. Gross margin percentage increased slightly due to a margin percent increase in More Personal Computing and segment sales mix, offset in part by margin percent declines in Productivity and Business Processes and Intelligent Cloud. Gross margin percentage includes a 5 percentage point improvement in commercial cloud gross margin primarily across Azure and Office 365.

Operating income increased $2.9 billion or 11%, primarily due to higher gross margin and lower impairment and restructuring expenses, offset in part by an increase in research and development and sales and marketing expenses. Operating income included an operating loss of $924 million related to the acquisition of LinkedIn, including $866 million of amortization of intangible assets. Operating income also included an unfavorable foreign currency impact of 3%. Key changes in expenses were:

- Cost of revenue increased $1.5 billion or 5%, mainly due to growth in our commercial cloud, the acquisition of LinkedIn, and higher Search advertising traffic acquisition costs, offset in part by a reduction in Phone sales and Gaming cost of revenue.
- Research and development expenses increased $1.0 billion or 9%, primarily due to LinkedIn expenses and increased investments in cloud engineering, offset in part by a reduction in Phone expenses.
- Sales and marketing expenses increased $826 million or 6%, primarily due to LinkedIn expenses and increased investments in sales capacity for our commercial cloud, offset in part by a reduction in Phone and marketing expenses.
- Impairment and restructuring expenses decreased $804 million, driven by asset impairment charges and restructuring charges related to our Phone business in fiscal year 2016, offset in part by employee severance expenses primarily related to our sales and marketing restructuring plan in fiscal year 2017.

Diluted EPS was $3.25 for fiscal year 2017, and was negatively impacted by restructuring expenses, which resulted in a decrease of $0.04. Diluted EPS was $2.56 for fiscal year 2016, and was negatively impacted by impairment and restructuring expenses, which resulted in a decrease of $0.11.

SEGMENT RESULTS OF OPERATIONS

(In millions, except percentages)	2018	2017	2016	Percentage Change 2018 Versus 2017	Percentage Change 2017 Versus 2016
Revenue					
Productivity and Business Processes	**$ 35,865**	$ 29,870	$ 25,792	20%	16%
Intelligent Cloud	**32,219**	27,407	24,952	18%	10%
More Personal Computing	**42,276**	39,294	40,410	8%	(3)%
Total	**$ 110,360**	$ 96,571	$ 91,154	14%	6%
Operating Income (Loss)					
Productivity and Business Processes	**$ 12,924**	$ 11,389	$ 11,756	13%	(3)%
Intelligent Cloud	**11,524**	9,127	9,249	26%	(1)%
More Personal Computing	**10,610**	8,815	6,183	20%	43%
Corporate and Other	**0**	(306)	(1,110)	*	*
Total	**$ 35,058**	$ 29,025	$ 26,078	21%	11%

* *Not meaningful*

Reportable Segments

Fiscal Year 2018 Compared with Fiscal Year 2017

Productivity and Business Processes

Revenue increased $6.0 billion or 20%.

- LinkedIn revenue increased $3.0 billion to $5.3 billion. Fiscal year 2018 includes a full period of results, whereas fiscal year 2017 only includes results from the date of acquisition on December 8, 2016. LinkedIn revenue primarily consisted of revenue from Talent Solutions.
- Office Commercial revenue increased $2.4 billion or 11%, driven by Office 365 commercial revenue growth, mainly due to growth in subscribers and average revenue per user, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.
- Office Consumer revenue increased $382 million or 11%, driven by Office 365 consumer revenue growth, mainly due to growth in subscribers.
- Dynamics revenue increased 13%, driven by Dynamics 365 revenue growth.

Operating income increased $1.5 billion or 13%, including a favorable foreign currency impact of 2%.

- Gross margin increased $4.4 billion or 19%, driven by LinkedIn and growth in Office commercial. Gross margin percentage decreased slightly, due to an increased mix of cloud offerings, offset in part by gross margin percentage improvement in Office 365 commercial and LinkedIn. LinkedIn cost of revenue increased $818 million to $1.7 billion, including $888 million of amortization for acquired intangible assets.
- Operating expenses increased $2.9 billion or 25%, driven by LinkedIn expenses and investments in commercial sales capacity and cloud engineering. LinkedIn operating expenses increased $2.2 billion to $4.5 billion, including $617 million of amortization of acquired intangible assets.

Intelligent Cloud

Revenue increased $4.8 billion or 18%.

- Server products and cloud services revenue increased $4.5 billion or 21%, driven by Azure and server products licensed on-premises revenue growth. Azure revenue growth of 91%, due to higher infrastructure-as-a-service and platform-as-a-service consumption-based and per user-based services. Server products licensed on-premises revenue increased 5%, mainly due to a higher mix of premium licenses for Windows Server and Microsoft SQL Server.

- Enterprise Services revenue increased $304 million or 5%, driven by higher revenue from Premier Support Services and Microsoft Consulting Services, offset in part by a decline in revenue from custom support agreements.

Operating income increased $2.4 billion or 26%.

- Gross margin increased $3.1 billion or 16%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies. Gross margin percentage decreased, due to an increased mix of cloud offerings, offset in part by gross margin percentage improvement in Azure.
- Operating expenses increased $683 million or 7%, driven by investments in commercial sales capacity and cloud engineering.

More Personal Computing

Revenue increased $3.0 billion or 8%.

- Windows revenue increased $925 million or 5%, driven by growth in Windows Commercial and Windows OEM, offset by a decline in patent licensing revenue. Windows Commercial revenue increased 12%, driven by multi-year agreement revenue growth. Windows OEM revenue increased 5%. Windows OEM Pro revenue grew 11%, ahead of a strengthening commercial PC market. Windows OEM non-Pro revenue declined 4%, below the consumer PC market, driven by continued pressure in the entry-level price category.
- Gaming revenue increased $1.3 billion or 14%, driven by Xbox software and services revenue growth of 20%, mainly from third-party title strength.
- Search advertising revenue increased $793 million or 13%. Search advertising revenue, excluding traffic acquisition costs, increased 16%, driven by growth in Bing, due to higher revenue per search and search volume.
- Surface revenue increased $625 million or 16%, driven by a higher mix of premium devices and an increase in volumes sold, due to the latest editions of Surface.
- Phone revenue decreased $525 million.

Operating income increased $1.8 billion or 20%, including a favorable foreign currency impact of 2%.

- Gross margin increased $2.2 billion or 11%, driven by growth in Windows, Surface, Search, and Gaming. Gross margin percentage increased, primarily due to gross margin percentage improvement in Surface.
- Operating expenses increased $391 million or 3%, driven by investments in Search, artificial intelligence, and Gaming engineering and commercial sales capacity, offset in part by a decrease in Windows marketing expenses.

Fiscal Year 2017 Compared with Fiscal Year 2016

Productivity and Business Processes

Revenue increased $4.1 billion or 16%.

- LinkedIn revenue was $2.3 billion, primarily comprised of revenue from Talent Solutions.
- Office Commercial revenue increased $1.4 billion or 7%, driven by higher revenue from Office 365 commercial, mainly due to growth in subscribers, offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 commercial.

- Office Consumer revenue increased $351 million or 11%, driven by higher revenue from Office 365 consumer, mainly due to growth in subscribers.
- Dynamics revenue increased 5%, primarily due to higher revenue from Dynamics 365.

Operating income decreased $367 million or 3%, including an unfavorable foreign currency impact of 2%.

- Operating expenses increased $2.3 billion or 26%, mainly due to LinkedIn and cloud engineering expenses. Operating expenses included $2.3 billion related to our acquisition of LinkedIn, including $359 million of amortization of acquired intangible assets. Sales and marketing expenses increased $1.2 billion or 24%, research and development expenses increased $955 million or 35%, and general and administrative expenses increased $212 million or 14%.
- Gross margin increased $2.0 billion or 9%, primarily due to our acquisition of LinkedIn. Gross margin percentage decreased, due to an increased mix of cloud offerings and amortization of acquired intangible assets related to LinkedIn. Cost of revenue included $918 million related to our acquisition of LinkedIn, including $507 million of amortization of acquired intangible assets.

Intelligent Cloud

Revenue increased $2.5 billion or 10%.

- Server products and cloud services revenue grew $2.6 billion or 14%, driven by Azure revenue growth of 98% and server products licensed on-premises revenue growth of 5%.
- Enterprise Services revenue decreased 2%, driven by a decline in revenue from custom support agreements, offset in part by higher revenue from Premier Support Services and Microsoft Consulting Services.

Operating income decreased $122 million or 1%, including an unfavorable foreign currency impact of 2%.

- Operating expenses increased $975 million or 11%, driven by investments in sales capacity, cloud engineering, and developer engagement. Sales and marketing expenses increased $549 million or 13%, research and development expenses increased $468 million or 14%, and general and administrative expenses decreased $42 million or 3%.
- Gross margin increased $853 million or 5%, driven by growth in server products and cloud services revenue and cloud services scale and efficiencies, offset in part by a decline in Enterprise Services gross margin. Gross margin percentage decreased, due to an increased mix of cloud offerings and lower Enterprise Services gross margin percent, offset by improvement in Azure gross margin percent.

More Personal Computing

Revenue decreased $1.1 billion or 3%.

- Windows revenue increased $1.0 billion or 6%, mainly due to higher revenue from Windows Commercial and Windows OEM. Windows Commercial revenue grew 14%, driven by multi-year agreement revenue. Windows OEM revenue increased 3%. Windows OEM Pro revenue grew 4%, outperforming the commercial PC market, primarily due to a higher mix of premium licenses sold. Windows OEM non-Pro revenue grew 3%, outperforming the consumer PC market, primarily due to a higher mix of premium devices sold.
- Search advertising revenue increased $791 million or 15%. Search advertising revenue, excluding traffic acquisition costs, increased 9%, primarily driven by growth in Bing, due to higher revenue per search and search volume.
- Gaming revenue decreased slightly, primarily due to lower Xbox hardware revenue, offset in part by higher revenue from Xbox software and services. Xbox hardware revenue decreased 21%, mainly due to lower prices of consoles sold and a decline in volume of consoles sold. Xbox software and services revenue increased 11%, driven by a higher volume of Xbox Live transactions and revenue per transaction.

- Surface revenue decreased $82 million or 2%, primarily due to a reduction in volumes sold, offset in part by a higher mix of premium devices.
- Phone revenue decreased $2.8 billion.

Operating income increased $2.6 billion or 43%, including an unfavorable foreign currency impact of 3%.

- Operating expenses decreased $1.5 billion or 12%, driven by a reduction in Phone expenses and Surface launch-related expenses in the prior year. Sales and marketing expenses decreased $893 million or 16%, research and development expenses decreased $374 million or 6%, and general and administrative expenses decreased $252 million or 16%.
- Gross margin increased $1.1 billion or 6%, driven by growth in Windows, Search advertising, and Gaming, offset in part by a decline in Phone and Surface. Gross margin percentage increased, due to favorable sales mix and gross margin percent improvements across Windows, Gaming, and Search advertising, offset by a gross margin percent decline in Devices.

Corporate and Other

Corporate and Other operating loss is comprised of corporate-level activity not specifically allocated to a segment, including impairment and restructuring expenses.

Fiscal Year 2018 Compared with Fiscal Year 2017

Corporate and Other operating loss decreased $306 million, due to a reduction in impairment and restructuring expenses, driven by employee severance expenses primarily related to our sales and marketing restructuring plan in fiscal year 2017.

Fiscal Year 2017 Compared with Fiscal Year 2016

Corporate and Other operating loss decreased $804 million, primarily due to a reduction in impairment and restructuring expenses, driven by asset impairment charges and restructuring charges related to our Phone business in fiscal year 2016, offset in part by employee severance expenses primarily related to our sales and marketing restructuring plan in fiscal year 2017.

OPERATING EXPENSES

Research and Development

(In millions, except percentages)	2018	2017	2016	Percentage Change 2018 Versus 2017	Percentage Change 2017 Versus 2016
Research and development	**$ 14,726**	$ 13,037	$ 11,988	13%	9%
As a percent of revenue	**13%**	13%	13%	0ppt	0ppt

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.

Fiscal Year 2018 Compared with Fiscal Year 2017

Research and development expenses increased $1.7 billion or 13%, primarily due to investments in cloud engineering and LinkedIn expenses. LinkedIn expenses increased $762 million to $1.5 billion.

Fiscal Year 2017 Compared with Fiscal Year 2016

Research and development expenses increased $1.0 billion or 9%, primarily due to LinkedIn expenses and increased investments in cloud engineering, offset in part by a reduction in Phone expenses. Expenses included $745 million related to our acquisition of LinkedIn.

Sales and Marketing

(In millions, except percentages)	2018	2017	2016	Percentage Change 2018 Versus 2017	Percentage Change 2017 Versus 2016
Sales and marketing	**$ 17,469**	$ 15,461	$ 14,635	13%	6%
As a percent of revenue	**16%**	16%	16%	0ppt	0ppt

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.

Fiscal Year 2018 Compared with Fiscal Year 2017

Sales and marketing expenses increased $2.0 billion or 13%, primarily due to LinkedIn expenses and investments in commercial sales capacity, offset in part by a decrease in Windows marketing expenses. LinkedIn expenses increased $1.2 billion to $2.5 billion, including $617 million of amortization of acquired intangible assets.

Fiscal Year 2017 Compared with Fiscal Year 2016

Sales and marketing expenses increased $826 million or 6%, primarily due to LinkedIn expenses and increased investments in sales capacity for our commercial cloud, offset in part by a reduction in Phone expenses and prior year marketing expenses primarily related to Surface, commercial, and Windows 10. Expenses included $1.2 billion related to our acquisition of LinkedIn, including $359 million of amortization of acquired intangible assets.

General and Administrative

(In millions, except percentages)	2018	2017	2016	Percentage Change 2018 Versus 2017	Percentage Change 2017 Versus 2016
General and administrative	**$ 4,754**	$ 4,481	$ 4,563	6%	(2)%
As a percent of revenue	**4%**	5%	5%	(1)ppt	0ppt

General and administrative expenses include payroll, employee benefits, stock-based compensation expense, severance expense, and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative personnel, certain taxes, and legal and other administrative fees.

Fiscal Year 2018 Compared with Fiscal Year 2017

General and administrative expenses increased $273 million or 6%, primarily due to LinkedIn expenses. LinkedIn expenses increased $234 million to $528 million.

Fiscal Year 2017 Compared with Fiscal Year 2016

General and administrative expenses decreased $82 million or 2%, primarily due to prior year investments in infrastructure supporting our business transformation, a reduction in Phone expenses, and lower employee-related expenses, offset in part by LinkedIn expenses. Expenses included $294 million related to our acquisition of LinkedIn.

IMPAIRMENT AND RESTRUCTURING EXPENSES

Impairment and restructuring expenses include costs associated with the impairment of intangible assets related to our Phone business, and employee severance expenses and other costs associated with the consolidation of facilities and manufacturing operations related to restructuring activities.

Fiscal Year 2018 Compared with Fiscal Year 2017

During fiscal year 2017, we recorded $306 million of employee severance expenses primarily related to our sales and marketing restructuring plan.

Fiscal Year 2017 Compared with Fiscal Year 2016

Impairment and restructuring expenses were $306 million for fiscal year 2017, compared to $1.1 billion for fiscal year 2016.

During fiscal year 2016, we recorded $630 million of asset impairment charges related to our Phone business. We also recorded $480 million of restructuring charges, including employee severance expenses and contract termination costs, primarily related to our previously announced Phone business restructuring plans.

OTHER INCOME (EXPENSE), NET

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

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Dividends and interest income	**$ 2,214**	$ 1,387	$ 903
Interest expense	**(2,733)**	(2,222)	(1,243)
Net recognized gains on investments	**2,399**	2,583	668
Net losses on derivatives	**(187)**	(510)	(443)
Net losses on foreign currency remeasurements	**(218)**	(111)	(129)
Other, net	**(59)**	(251)	(195)
Total	**$ 1,416**	$ 876	$ (439)

We use derivative instruments to: manage risks related to foreign currencies, equity prices, interest rates, and credit; enhance investment returns; and facilitate portfolio diversification. Gains and losses from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense), net.

Fiscal Year 2018 Compared with Fiscal Year 2017

Dividends and interest income increased primarily due to higher average portfolio balances and yields on fixed-income securities. Interest expense increased primarily due to higher average outstanding long-term debt and higher finance lease expense. Net recognized gains on investments decreased primarily due to higher losses on sales of fixed-income securities, offset in part by higher gains on sales of equity securities. Net losses on derivatives decreased primarily due to lower losses on equity, foreign exchange, and commodity derivatives, offset in part by losses on interest rate derivatives in the current period as compared to gains in the prior period.

Fiscal Year 2017 Compared with Fiscal Year 2016

Dividends and interest income increased primarily due to higher portfolio balances and yields on fixed-income securities. Interest expense increased primarily due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities. Net losses on derivatives increased due to higher losses on equity derivatives, offset in part by lower losses on commodity and foreign currency derivatives. Other, net reflects recognized losses from certain joint ventures and divestitures.

INCOME TAXES

Effective Tax Rate

Fiscal Year 2018 Compared with Fiscal Year 2017

Our effective tax rate for fiscal years 2018 and 2017 was 55% and 15%, respectively. The increase in our effective tax rate for fiscal year 2018 compared to fiscal year 2017 was primarily due to the net charge related to the enactment of the TCJA in fiscal year 2018 and the realization of tax benefits attributable to previous Phone business losses in fiscal year 2017. Our effective tax rate was higher than the U.S. federal statutory rate primarily due to the net charge related to the enactment of the TCJA, offset in part by earnings taxed at lower rates in foreign jurisdictions resulting from our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

The mix of income before income taxes between the U.S. and foreign countries impacted our effective tax rate as a result of the geographic distribution of, and customer demand for, our products and services. In fiscal year 2018, our U.S. income before income taxes was $11.5 billion and our foreign income before income taxes was $24.9 billion. In fiscal year 2017, our U.S. income before income taxes was $6.8 billion and our foreign income before income taxes was $23.1 billion.

Fiscal Year 2017 Compared with Fiscal Year 2016

Our effective tax rate for fiscal years 2017 and 2016 was 15% and 20%, respectively. The decrease in our effective tax rate for fiscal year 2017 compared to fiscal year 2016 was primarily due to the realization of tax benefits attributable to previous Phone business losses, offset in part by changes in the mix of our income before income taxes between the U.S. and foreign countries. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

The mix of income before income taxes between the U.S. and foreign countries impacted our effective tax rate as a result of the geographic distribution of, and customer demand for, our products and services. In fiscal year 2017, our U.S. income before income taxes was $6.8 billion and our foreign income before income taxes was $23.1 billion. In fiscal year 2016, our U.S. income before income taxes was $5.1 billion and our foreign income before income taxes was $20.5 billion.

Recent Tax Legislation

On December 22, 2017, the TCJA was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business, such as imposing a one-time transition tax on deemed repatriation of deferred foreign income, reducing the U.S. federal statutory tax rate, and adopting a territorial tax system. The TCJA required us to incur a one-time transition tax on deferred foreign income not previously subject to U.S. income tax at a rate of 15.5% for foreign cash and certain other net current assets, and 8% on the remaining income. The TCJA also reduced the U.S. federal statutory tax rate from 35% to 21% effective January 1, 2018. For fiscal year 2018, our blended U.S. federal statutory tax rate is 28.1%. This is the result of using the tax rate of 35% for the first and second quarter of fiscal year 2018 and the reduced tax rate of 21% for the third and fourth quarter of fiscal year 2018. The TCJA includes a provision to tax global intangible low-taxed income ("GILTI") of foreign subsidiaries and a base erosion anti-abuse tax ("BEAT") measure that taxes certain payments between a U.S. corporation and its foreign subsidiaries. The GILTI and BEAT provisions of the TCJA will be effective for us beginning July 1, 2018.

The TCJA was effective in the second quarter of fiscal year 2018. As of June 30, 2018, we have not completed our accounting for the estimated tax effects of the TCJA. During fiscal year 2018, we recorded a provisional net charge of

$13.7 billion related to the TCJA based on reasonable estimates for those tax effects. Due to the timing of the enactment and the complexity in applying the provisions of the TCJA, the provisional net charge is subject to revisions as we continue to complete our analysis of the TCJA, collect and prepare necessary data, and interpret any additional guidance issued by the U.S. Treasury Department, Internal Revenue Service ("IRS"), Financial Accounting Standards Board, and other standard-setting and regulatory bodies. Adjustments may materially impact our provision for income taxes and effective tax rate in the period in which the adjustments are made. Our accounting for the estimated tax effects of the TCJA will be completed during the measurement period, which is not expected to extend beyond one year from the enactment date.

During fiscal year 2018, we recorded an estimated net charge of $13.7 billion related to the TCJA, due to the impact of the one-time transition tax on the deemed repatriation of deferred foreign income of $17.9 billion, offset in part by the impact of changes in the tax rate of $4.2 billion, primarily on deferred tax assets and liabilities.

Uncertain Tax Positions

While we settled a portion of the IRS audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and 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 the second quarter of fiscal year 2018, we settled a portion of the IRS audit for tax years 2010 to 2013. We continue to be subject to examination by the IRS for tax years 2010 to 2017. 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, 2018, the primary unresolved issue relates to transfer pricing, which could have a significant impact in 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 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 2017, some of which are currently under audit by local tax authorities. The resolution of each of these audits is not expected to be material to our consolidated financial statements.

NON-GAAP FINANCIAL MEASURES

Adjusted operating income, net income and diluted earnings per share are non-GAAP financial measures which exclude the net charge related to the TCJA, and impairment and restructuring expenses. We believe these non-GAAP measures aid investors by providing additional insight into our operational performance and help clarify trends affecting our business. For comparability of reporting, management considers non-GAAP measures in conjunction with GAAP financial results in evaluating business performance. These non-GAAP financial measures presented should not be considered a substitute for, or superior to, the measures of financial performance prepared in accordance with GAAP.

The following table reconciles our financial results reported in accordance with GAAP to non-GAAP financial results:

(In millions, except percentages and per share amounts)	2018	2017	2016	Percentage Change 2018 Versus 2017	Percentage Change 2017 Versus 2016
Operating income	**$ 35,058**	$ 29,025	$ 26,078	21%	11%
Net charge related to the TCJA	**0**	0	0		
Impairment and restructuring expenses	**0**	306	1,110		
Adjusted operating income	**$ 35,058**	$ 29,331	$ 27,188	20%	8%
Net income	**$ 16,571**	$ 25,489	$ 20,539	(35)%	24%
Net charge related to the TCJA	**13,696**	0	0		
Impairment and restructuring expenses	**0**	243	895		
Adjusted net income	**$ 30,267**	$ 25,732	$ 21,434	18%	20%
Diluted earnings per share	**$ 2.13**	$ 3.25	$ 2.56	(34)%	27%
Net charge related to the TCJA	**1.75**	0	0		
Impairment and restructuring expenses	**0**	0.04	0.11		
Adjusted diluted earnings per share	**$ 3.88**	$ 3.29	$ 2.67	18%	23%

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $133.8 billion and $133.0 billion as of June 30, 2018 and 2017, respectively. Equity and other investments were $1.9 billion and $6.0 billion as of June 30, 2018 and 2017, respectively. Our short-term investments are primarily intended to facilitate liquidity and capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities.

As a result of the TCJA, our cash, cash equivalents, and short-term investments held by foreign subsidiaries are no longer subject to U.S. tax on repatriation into the U.S.

Valuation

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our financial instruments. This pricing methodology applies to our Level 1 investments, such as U.S. government securities, common and preferred stock, and mutual funds. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government bonds, mortgage- and asset-backed securities, commercial paper, certificates of deposit, and U.S. agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured at fair value on a recurring basis using unobservable inputs are an immaterial portion of our portfolio.

A majority of our investments are priced by pricing vendors and are generally Level 1 or Level 2 investments as these vendors either provide a quoted market price in an active market or use observable inputs for their pricing without applying significant adjustments. Broker pricing is used mainly when a quoted price is not available, the investment is not priced by our pricing vendors, or when a broker price is more reflective of fair values in the market in which the investment trades. Our broker-priced investments are generally classified as Level 2 investments because the broker prices these investments based on similar assets without applying significant adjustments. In addition, all our broker-priced investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments. Our fair value processes include controls that are designed to ensure appropriate fair values are recorded. These controls include model validation, review of key model inputs, analysis of period-over-period fluctuations, and independent recalculation of prices where appropriate.

Cash Flows

Fiscal Year 2018 Compared with Fiscal Year 2017

Cash from operations increased $4.4 billion to $43.9 billion for the fiscal year ended June 30, 2018, mainly due to an increase in cash received from customers, offset in part by an increase in cash paid to employees, net cash paid for income taxes, cash paid for interest on debt, and cash paid to suppliers. Cash used in financing was $33.6 billion for the fiscal year ended June 30, 2018, compared to cash from financing of $8.4 billion for the fiscal year ended June 30, 2017. The change was mainly due to a $41.7 billion decrease in proceeds from issuance of debt, net of repayments, offset in part by a $1.1 billion decrease in cash used for common stock repurchases. Cash used in investing decreased $40.7 billion to $6.1 billion for the fiscal year ended June 30, 2018, mainly due to a $25.1 billion decrease in cash used for acquisitions of companies, net of cash acquired, and purchases of intangible and other assets, and a $19.1 billion increase in cash from net investment purchases, sales, and maturities.

Fiscal Year 2017 Compared with Fiscal Year 2016

Cash from operations increased $6.2 billion to $39.5 billion during the fiscal year, mainly due to an increase in cash received from customers and an income tax refund for overpayment of estimated taxes, offset in part by an increase in cash paid to employees. Cash from financing increased $16.8 billion to $8.4 billion, mainly due to a $13.2 billion increase in proceeds from issuances of debt, net of repayments, and a $4.2 billion decrease in cash used for common stock repurchases, offset in part by an $839 million increase in dividends paid. Cash used in investing increased $22.8 billion to $46.8 billion, mainly due to a $24.6 billion increase in cash used for acquisitions of companies, net of cash acquired, and purchases of intangibles and other assets, offset in part by a $1.9 billion decrease in cash used for net investment purchases, sales, and maturities.

Debt

We issued debt to take advantage of favorable pricing and liquidity in the debt markets, reflecting our credit rating and the low interest rate environment. The proceeds of these issuances were or will be used for general corporate purposes, which may include, among other things, funding for working capital, capital expenditures, repurchases of capital stock, acquisitions, and repayment of existing debt. Refer to Note 12 – Debt of the Notes to Financial Statements for further discussion.

Unearned Revenue

Unearned revenue comprises mainly unearned revenue related to volume licensing programs and includes Software Assurance ("SA") and cloud services. Unearned revenue is generally billed upfront at the beginning of each annual coverage period for multi-year agreements and recognized ratably over the coverage period. Unearned revenue also includes payments for other offerings for which we have been paid in advance and earn the revenue when we transfer control of the product or service. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements for further discussion.

The following table outlines the expected future recognition of unearned revenue as of June 30, 2018:

(In millions)	
Three Months Ending,	
September 30, 2018	$ 11,081
December 31, 2018	8,688
March 31, 2019	5,995
June 30, 2019	3,141
Thereafter	3,815
Total	$ 32,720

If our customers choose to license cloud-based versions of our products and services rather than licensing transaction-based products and services, the associated revenue will shift from being recognized at the time of the transaction to being recognized over the subscription period or upon consumption, as applicable.

Share Repurchases

For the fiscal years ended June 30, 2018, 2017, and 2016, we repurchased 99 million shares, 170 million shares, and 294 million shares of our common stock for $8.6 billion, $10.3 billion, and $14.8 billion, respectively, through our share repurchase programs. All repurchases were made using cash resources. Refer to Note 18 – Stockholders' Equity of the Notes to Financial Statements for further discussion.

Dividends

Refer to Note 18 – Stockholders' Equity of the Notes to Financial Statements for further discussion.

Off-Balance Sheet Arrangements

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. In evaluating estimated losses on these obligations, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. These obligations did not have a material impact in our consolidated financial statements during the periods presented.

Contractual Obligations

The following table summarizes the payments due by fiscal year for our outstanding contractual obligations as of June 30, 2018:

(In millions)	2019	2020-2021	2022-2023	Thereafter	Total
Long-term debt: (a)					
Principal payments	$ 4,000	$ 9,268	$ 10,794	$ 52,836	$ 76,898
Interest payments	2,377	4,495	4,066	31,247	42,185
Construction commitments (b)	1,793	107	0	0	1,900
Operating leases, including imputed interest (c)	1,538	2,567	1,778	2,416	8,299
Finance leases, including imputed interest (c)	470	1,101	1,142	5,751	8,464
Transition tax (d)	1,495	2,808	2,808	10,530	17,641
Purchase commitments (e)	19,321	874	255	408	20,858
Other long-term liabilities (f)	0	76	19	313	408
Total contractual obligations	$ 30,994	$ 21,296	$ 20,862	$ 103,501	$ 176,653

(a) *Refer to Note 12 – Debt of the Notes to Financial Statements.*
(b) *Refer to Note 8 – Property and Equipment of the Notes to Financial Statements.*

(c) *Refer to Note 16 – Leases of the Notes to Financial Statements.*
(d) *Refer to Note 13 – Income Taxes of the Notes to Financial Statements.*
(e) *Amounts represent purchase commitments, including open purchase orders and take-or-pay contracts that are not presented as construction commitments above.*
(f) *We have excluded long-term tax contingencies, other tax liabilities, and deferred income taxes of $13.6 billion from the amounts presented as the timing of these obligations is uncertain. We have also excluded unearned revenue and non-cash items.*

Other Planned Uses of Capital

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology, as well as continue making acquisitions that align with our business strategy. Additions to property and equipment will continue, including new facilities, datacenters, and computer systems for research and development, sales and marketing, support, and administrative staff. We expect capital expenditures to increase in coming years to support growth in our cloud offerings. We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

Liquidity

As a result of the TCJA, we are required to pay a one-time transition tax of $17.9 billion on deferred foreign income not previously subject to U.S. income tax. In fiscal year 2018, we paid transition tax of $228 million. Under the TCJA, the remaining transition tax of $17.6 billion is payable interest-free over eight years, with 8% due in each of the first five years, 15% in year six, 20% in year seven, and 25% in year eight.

We expect existing cash, cash equivalents, short-term investments, cash flows from operations, and access to capital markets to continue to be sufficient to fund our operating activities and cash commitments for investing and financing activities, such as dividends, share repurchases, debt maturities, material capital expenditures, and the transition tax related to the TCJA, for at least the next 12 months and thereafter for the foreseeable future.

RECENT ACCOUNTING GUIDANCE

Refer to Note 1 – Accounting Policies of the Notes to Financial Statements for further discussion.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements and accompanying notes are prepared in accordance with GAAP. Preparing consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us include revenue recognition, impairment of investment securities, goodwill, research and development costs, contingencies, income taxes, and inventories.

Revenue Recognition

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. When a cloud-based service includes both on-premises software licenses and cloud services, judgment is required to determine whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time. Certain cloud services, primarily Office 365, depend on a significant level of integration, interdependency, and interrelation between the desktop applications and cloud services, and are accounted for together as one performance obligation. Revenue from Office 365 is recognized ratably over the period in which the cloud services are provided.

Judgment is required to determine the stand-alone selling price ("SSP") for each distinct performance obligation. We use a single amount to estimate SSP for items that are not sold separately, including on-premises licenses sold with SA or software updates provided at no additional charge. We use a range of amounts to estimate SSP when we sell each of the products and services separately and need to determine whether there is a discount to be allocated based on the relative SSP of the various products and services.

In instances where SSP is not directly observable, such as when we do not sell the product or service separately, we determine the SSP using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual products and services due to the stratification of those products and services by customers and circumstances. In these instances, we may use information such as the size of the customer and geographic region in determining the SSP.

Due to the various benefits from and the nature of our SA program, judgment is required to assess the pattern of delivery, including the exercise pattern of certain benefits across our portfolio of customers.

Our products are generally sold with a right of return, we may provide other credits or incentives, and in certain instances we estimate customer usage of our products and services, which are accounted for as variable consideration when determining the amount of revenue to recognize. Returns and credits are estimated at contract inception and updated at the end of each reporting period if additional information becomes available. Changes to our estimated variable consideration were not material for the periods presented.

The new standard related to revenue recognition had a material impact in our consolidated financial statements. Refer to Note 1 – Accounting Policies of the Notes to Financial Statements for further discussion.

Impairment of Investment Securities

We review investments quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly 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. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

Goodwill

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. 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. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit.

Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated primarily through the use of a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital.

The estimates used to calculate the fair value of a reporting unit change from year to year based on operating results, market conditions, and other factors. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit.

Research and Development Costs

Costs incurred internally in researching and developing a computer software product are charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all software costs are capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through coding and testing. Generally, this occurs shortly before the products are released to production. The amortization of these costs is included in cost of revenue over the estimated life of the products.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our consolidated financial statements.

Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year, and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting literature also provides guidance on derecognition of income tax assets and liabilities, classification of deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our consolidated financial statements.

The TCJA significantly changes existing U.S. tax law and includes numerous provisions that affect our business. Refer to Note 13 – Income Taxes of the Notes to Financial Statements for further discussion.

Inventories

Inventories are stated at average cost, subject to the lower of cost or net realizable value. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. Net realizable value is the estimated selling price less estimated costs of completion, disposal, and transportation. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. These reviews include analysis of demand forecasts, product life cycle status, product development plans, current sales levels, pricing strategy, and component cost trends. 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.

STATEMENT OF MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

Management is responsible for the preparation of the consolidated financial statements and related information that are presented in this report. The consolidated financial statements, which include amounts based on management's estimates and judgments, have been prepared in conformity with accounting principles generally accepted in the United States of America.

The Company designs and maintains accounting and internal control systems to provide reasonable assurance at reasonable cost that assets are safeguarded against loss from unauthorized use or disposition, and that the financial records are reliable for preparing consolidated financial statements and maintaining accountability for assets. These systems are augmented by written policies, an organizational structure providing division of responsibilities, careful selection and training of qualified personnel, and a program of internal audits.

The Company engaged Deloitte & Touche LLP, an independent registered public accounting firm, to audit and render an opinion on the consolidated financial statements and internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States).

The Board of Directors, through its Audit Committee, consisting solely of independent directors of the Company, meets periodically with management, internal auditors, and our independent registered public accounting firm to ensure that each is meeting its responsibilities and to discuss matters concerning internal controls and financial reporting. Deloitte & Touche LLP and the internal auditors each have full and free access to the Audit Committee.

Satya Nadella
Chief Executive Officer

Amy E. Hood
Executive Vice President and Chief Financial Officer

Frank H. Brod
Corporate Vice President, Finance and Administration;
Chief Accounting Officer

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign exchange rates, interest rates, credit risk, and equity prices. We use derivatives instruments to manage these risks, however, they may still impact our consolidated financial statements.

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 positions. Principal currencies hedged include the euro, Japanese yen, British pound, Canadian dollar, and Australian dollar.

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 the fixed-income portfolio to achieve economic returns that correlate to certain global fixed-income indices.

Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We manage credit exposures relative to broad-based indices and to facilitate portfolio diversification.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk.

SENSITIVITY ANALYSIS

Historically, we used a value-at-risk ("VaR") model to estimate and quantify our market risks. This included presenting one-day VaR as well as average, high, and low VaR by risk category throughout the reporting period. Given the changes in size and allocation of our portfolio of financial assets, we believe sensitivity analysis is more informative in representing the potential impact to the portfolio as a result of market movements. Therefore, we have presented a sensitivity analysis for each risk category below.

Sensitivity analysis is not intended to represent actual losses in fair value, including determinations of other-than-temporary losses in fair value in accordance with accounting principles generally accepted in the United States of America, but is used as a risk estimation and management tool.

The following table sets forth the potential loss in future earnings or fair values, including associated derivatives, resulting from hypothetical changes in relevant market rates or prices:

(In millions)

Risk Categories	Hypothetical Change	June 30, 2018	June 30, 2017	Impact
Foreign currency – Revenue	10% decrease in foreign exchange rates	**$ (2,187)**	$ (1,785)	Earnings
Foreign currency – Investments	10% decrease in foreign exchange rates	**(70)**	(92)	Fair Value
Interest rate	100 basis point increase in U.S. treasury interest rates	**(2,705)**	(2,394)	Fair Value
Credit	100 basis point increase in credit spreads	**(232)**	(167)	Fair Value
Equity	10% decrease in equity market prices	**(140)**	(323)	Fair Value

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,	**2018**	**2017**	**2016**
Revenue:			
Product	**$ 64,497**	$ 63,811	$ 67,336
Service and other	**45,863**	32,760	23,818
Total revenue	**110,360**	96,571	91,154
Cost of revenue:			
Product	**15,420**	15,175	17,880
Service and other	**22,933**	19,086	14,900
Total cost of revenue	**38,353**	34,261	32,780
Gross margin	**72,007**	62,310	58,374
Research and development	**14,726**	13,037	11,988
Sales and marketing	**17,469**	15,461	14,635
General and administrative	**4,754**	4,481	4,563
Impairment and restructuring	**0**	306	1,110
Operating income	**35,058**	29,025	26,078
Other income (expense), net	**1,416**	876	(439)
Income before income taxes	**36,474**	29,901	25,639
Provision for income taxes	**19,903**	4,412	5,100
Net income	**$ 16,571**	$ 25,489	$ 20,539
Earnings per share:			
Basic	**$ 2.15**	$ 3.29	$ 2.59
Diluted	**$ 2.13**	$ 3.25	$ 2.56
Weighted average shares outstanding:			
Basic	**7,700**	7,746	7,925
Diluted	**7,794**	7,832	8,013
Cash dividends declared per common share	**$ 1.68**	$ 1.56	$ 1.44

Refer to accompanying notes.

COMPREHENSIVE INCOME STATEMENTS

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Net income	**$ 16,571**	$ 25,489	$ 20,539
Other comprehensive income (loss), net of tax:			
Net change related to derivatives	**39**	(218)	(238)
Net change related to investments	**(2,717)**	(1,116)	(228)
Translation adjustments and other	**(178)**	167	(262)
Other comprehensive loss	**(2,856)**	(1,167)	(728)
Comprehensive income	**$ 13,715**	$ 24,322	$ 19,811

Refer to accompanying notes. Refer to Note 19 – Accumulated Other Comprehensive Income (Loss) for further information.

BALANCE SHEETS

(In millions)

June 30,	**2018**	**2017**
Assets		
Current assets:		
Cash and cash equivalents	**$ 11,946**	$ 7,663
Short-term investments	**121,822**	125,318
Total cash, cash equivalents, and short-term investments	**133,768**	132,981
Accounts receivable, net of allowance for doubtful accounts of **$377** and $345	**26,481**	22,431
Inventories	**2,662**	2,181
Other	**6,751**	5,103
Total current assets	**169,662**	162,696
Property and equipment, net of accumulated depreciation of **$29,223** and $24,179	**29,460**	23,734
Operating lease right-of-use assets	**6,686**	6,555
Equity and other investments	**1,862**	6,023
Goodwill	**35,683**	35,122
Intangible assets, net	**8,053**	10,106
Other long-term assets	**7,442**	6,076
Total assets	**$ 258,848**	$ 250,312
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	**$ 8,617**	$ 7,390
Short-term debt	**0**	9,072
Current portion of long-term debt	**3,998**	1,049
Accrued compensation	**6,103**	5,819
Short-term income taxes	**2,121**	718
Short-term unearned revenue	**28,905**	24,013
Other	**8,744**	7,684
Total current liabilities	**58,488**	55,745
Long-term debt	**72,242**	76,073
Long-term income taxes	**30,265**	13,485
Long-term unearned revenue	**3,815**	2,643
Deferred income taxes	**541**	5,734
Operating lease liabilities	**5,568**	5,372
Other long-term liabilities	**5,211**	3,549
Total liabilities	**176,130**	162,601
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital – shares authorized 24,000; outstanding **7,677** and 7,708	**71,223**	69,315
Retained earnings	**13,682**	17,769
Accumulated other comprehensive income (loss)	**(2,187)**	627
Total stockholders' equity	**82,718**	87,711
Total liabilities and stockholders' equity	**$ 258,848**	$ 250,312

Refer to accompanying notes.

CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Operations			
Net income	**$ 16,571**	$ 25,489	$ 20,539
Adjustments to reconcile net income to net cash from operations:			
Asset impairments	**0**	0	630
Depreciation, amortization, and other	**10,261**	8,778	6,622
Stock-based compensation expense	**3,940**	3,266	2,668
Net recognized gains on investments and derivatives	**(2,212)**	(2,073)	(223)
Deferred income taxes	**(5,143)**	(829)	2,479
Changes in operating assets and liabilities:			
Accounts receivable	**(3,862)**	(1,216)	562
Inventories	**(465)**	50	600
Other current assets	**(952)**	1,028	(1,212)
Other long-term assets	**(285)**	(917)	(1,110)
Accounts payable	**1,148**	81	88
Unearned revenue	**5,922**	3,820	2,565
Income taxes	**18,183**	1,792	(298)
Other current liabilities	**798**	356	(179)
Other long-term liabilities	**(20)**	(118)	(406)
Net cash from operations	**43,884**	39,507	33,325
Financing			
Proceeds from issuance (repayments) of short-term debt, maturities of 90 days or less, net	**(7,324)**	(4,963)	7,195
Proceeds from issuance of debt	**7,183**	44,344	13,884
Repayments of debt	**(10,060)**	(7,922)	(2,796)
Common stock issued	**1,002**	772	668
Common stock repurchased	**(10,721)**	(11,788)	(15,969)
Common stock cash dividends paid	**(12,699)**	(11,845)	(11,006)
Other, net	**(971)**	(190)	(369)
Net cash from (used in) financing	**(33,590)**	8,408	(8,393)
Investing			
Additions to property and equipment	**(11,632)**	(8,129)	(8,343)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(888)**	(25,944)	(1,393)
Purchases of investments	**(137,380)**	(176,905)	(129,758)
Maturities of investments	**26,360**	28,044	22,054
Sales of investments	**117,577**	136,350	93,287
Securities lending payable	**(98)**	(197)	203
Net cash used in investing	**(6,061)**	(46,781)	(23,950)
Effect of foreign exchange rates on cash and cash equivalents	**50**	19	(67)
Net change in cash and cash equivalents	**4,283**	1,153	915
Cash and cash equivalents, beginning of period	**7,663**	6,510	5,595
Cash and cash equivalents, end of period	**$ 11,946**	$ 7,663	$ 6,510

Refer to accompanying notes.

STOCKHOLDERS' EQUITY STATEMENTS

(In millions)

Year Ended June 30,	2018	2017	2016
Common stock and paid-in capital			
Balance, beginning of period	**$ 69,315**	$ 68,178	$ 68,465
Common stock issued	**1,002**	772	668
Common stock repurchased	**(3,033)**	(2,987)	(3,689)
Stock-based compensation expense	**3,940**	3,266	2,668
Other, net	**(1)**	86	66
Balance, end of period	**71,223**	69,315	68,178
Retained earnings			
Balance, beginning of period	**17,769**	13,118	16,191
Net income	**16,571**	25,489	20,539
Common stock cash dividends	**(12,917)**	(12,040)	(11,329)
Common stock repurchased	**(7,699)**	(8,798)	(12,283)
Cumulative effect of accounting change	**(42)**	0	0
Balance, end of period	**13,682**	17,769	13,118
Accumulated other comprehensive income (loss)			
Balance, beginning of period	**627**	1,794	2,522
Other comprehensive loss	**(2,856)**	(1,167)	(728)
Cumulative effect of accounting change	**42**	0	0
Balance, end of period	**(2,187)**	627	1,794
Total stockholders' equity	**$ 82,718**	$ 87,711	$ 83,090

Refer to accompanying notes.

NOTES TO FINANCIAL STATEMENTS

NOTE 1 — ACCOUNTING POLICIES

Accounting Principles

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

We have recast certain prior period income tax liabilities as discussed in the Recent Tax Legislation section below. We have also recast prior period securities lending payables to other current liabilities in our consolidated balance sheets to conform to the current period presentation. These items had no impact in our consolidated income statements or net cash from or used in operating, financing, or investing in our consolidated cash flows statements.

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 for 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 for which we are not able to exercise significant influence over the investee and which do not have readily determinable fair values are accounted for under the cost method.

Estimates and Assumptions

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples of estimates and assumptions include: for revenue recognition, determining the nature and timing of satisfaction of performance obligations, and determining the standalone selling price ("SSP") of performance obligations, variable consideration, and other obligations such as product returns and refunds; 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; the market value of, and demand for, our inventory; stock-based compensation forfeiture rates; when technological feasibility is achieved for our products; the potential outcome of future tax consequences of events that have been recognized in 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").

Revenue

Product Revenue and Service and Other Revenue

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

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

Revenue Recognition

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration we expect to receive in exchange for those products or services. We enter into contracts that can include various combinations of products and services, which are generally capable of being distinct and accounted for as separate performance obligations. Revenue is recognized net of allowances for returns and any taxes collected from customers, which are subsequently remitted to governmental authorities.

Nature of Products and Services

Licenses for on-premises software provide the customer with a right to use the software as it exists when made available to the customer. Customers may purchase perpetual licenses or subscribe to licenses, which provide customers with the same functionality and differ mainly in the duration over which the customer benefits from the software. Revenue from distinct on-premises licenses is recognized upfront at the point in time when the software is made available to the customer. In cases where we allocate revenue to software updates, primarily because the updates are provided at no additional charge, revenue is recognized as the updates are provided, which is generally ratably over the estimated life of the related device or license.

Certain volume licensing programs, including Enterprise Agreements, include on-premises licenses combined with Software Assurance (“SA”). SA conveys rights to new software and upgrades released over the contract period and provides support, tools, and training to help customers deploy and use products more efficiently. On-premises licenses are considered distinct performance obligations when sold with SA. Revenue allocated to SA is generally recognized ratably over the contract period as customers simultaneously consume and receive benefits, given that SA comprises distinct performance obligations that are satisfied over time.

Cloud services, which allow customers to use hosted software over the contract period without taking possession of the software, are provided on either a subscription or consumption basis. Revenue related to cloud services provided on a subscription basis is recognized ratably over the contract period. Revenue related to cloud services provided on a consumption basis, such as the amount of storage used in a period, is recognized based on the customer utilization of such resources. When cloud services require a significant level of integration and interdependency with software and the individual components are not considered distinct, all revenue is recognized over the period in which the cloud services are provided.

Revenue from search advertising is recognized when the advertisement appears in the search results or when the action necessary to earn the revenue has been completed. Revenue from consulting services is recognized as services are provided.

Our hardware is generally highly dependent on, and interrelated with, the underlying operating system and cannot function without the operating system. In these cases, the hardware and software license are accounted for as a single performance obligation and revenue is recognized at the point in time when ownership is transferred to resellers or directly to end customers through retail stores and online marketplaces.

Refer to Note 21 – Segment Information and Geographic Data for further information, including revenue by significant product and service offering.

Significant Judgments

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. When a cloud-based service includes both on-premises software licenses and cloud services, judgment is required to determine whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time. Certain cloud services, primarily Office 365, depend on a significant level of integration, interdependency, and interrelation between the desktop applications and cloud services, and are accounted for together as one performance obligation. Revenue from Office 365 is recognized ratably over the period in which the cloud services are provided.

Judgment is required to determine the SSP for each distinct performance obligation. We use a single amount to estimate SSP for items that are not sold separately, including on-premises licenses sold with SA or software updates provided at no additional charge. We use a range of amounts to estimate SSP when we sell each of the products and services separately and need to determine whether there is a discount to be allocated based on the relative SSP of the various products and services.

In instances where SSP is not directly observable, such as when we do not sell the product or service separately, we determine the SSP using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual products and services due to the stratification of those products and services by customers and circumstances. In these instances, we may use information such as the size of the customer and geographic region in determining the SSP.

Due to the various benefits from and the nature of our SA program, judgment is required to assess the pattern of delivery, including the exercise pattern of certain benefits across our portfolio of customers.

Our products are generally sold with a right of return, we may provide other credits or incentives, and in certain instances we estimate customer usage of our products and services, which are accounted for as variable consideration when determining the amount of revenue to recognize. Returns and credits are estimated at contract inception and updated at the end of each reporting period if additional information becomes available. Changes to our estimated variable consideration were not material for the periods presented.

Contract Balances

Timing of revenue recognition may differ from the timing of invoicing to customers. We record a receivable when revenue is recognized prior to invoicing, or unearned revenue when revenue is recognized subsequent to invoicing. For multi-year agreements, we generally invoice customers annually at the beginning of each annual coverage period. We record a receivable related to revenue recognized for multi-year on-premises licenses as we have an unconditional right to invoice and receive payment in the future related to those licenses.

The opening balance of current and long-term accounts receivable, net of allowance for doubtful accounts, was $22.3 billion as of July 1, 2016.

As of June 30, 2018 and 2017, long-term accounts receivable, net of allowance for doubtful accounts, were $1.8 billion and $1.7 billion, respectively, and are included in other long-term assets in our consolidated balance sheets.

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

Activity in the allowance for doubtful accounts was as follows:

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Balance, beginning of period	**$ 361**	$ 409	$ 289
Charged to costs and other	**134**	58	175
Write-offs	**(98)**	(106)	(55)
Balance, end of period	**$ 397**	$ 361	$ 409

Allowance for doubtful accounts included in our consolidated balance sheets:

June 30,	2018	2017	2016
Accounts receivable, net of allowance for doubtful accounts	**$ 377**	$ 345	$ 392
Other long-term assets	**20**	16	17
Total	**$ 397**	$ 361	$ 409

Unearned revenue comprises mainly unearned revenue related to volume licensing programs, which may include SA and cloud services. Unearned revenue is generally invoiced annually at the beginning of each contract period for multi-year agreements and recognized ratably over the coverage period. Unearned revenue also includes payments for consulting services to be performed in the future; LinkedIn subscriptions; Office 365 subscriptions; Xbox Live subscriptions; Windows 10 post-delivery support; Dynamics business solutions; Skype prepaid credits and subscriptions; and other offerings for which we have been paid in advance and earn the revenue when we transfer control of the product or service.

Refer to Note 15 – Unearned Revenue for further information, including unearned revenue by segment and changes in unearned revenue during the period.

Payment terms and conditions vary by contract type, although terms generally include a requirement of payment within 30 to 60 days. In instances where the timing of revenue recognition differs from the timing of invoicing, we have determined our contracts generally do not include a significant financing component. The primary purpose of our invoicing terms is to provide customers with simplified and predictable ways of purchasing our products and services, not to receive financing from our customers or to provide customers with financing. Examples include invoicing at the beginning of a subscription term with revenue recognized ratably over the contract period, and multi-year on-premises licenses that are invoiced annually with revenue recognized upfront.

Assets Recognized from Costs to Obtain a Contract with a Customer

We recognize an asset for the incremental costs of obtaining a contract with a customer if we expect the benefit of those costs to be longer than one year. We have determined that certain sales incentive programs meet the requirements to be capitalized. Total capitalized costs to obtain a contract were immaterial during the periods presented and are included in other current and long-term assets in our consolidated balance sheets.

We apply a practical expedient to expense costs as incurred for costs to obtain a contract with a customer when the amortization period would have been one year or less. These costs include our internal sales force compensation program and certain partner sales incentive programs as we have determined annual compensation is commensurate with annual sales activities.

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 original equipment manufacturers ("OEM"), 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 production. 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, $1.5 billion, and $1.6 billion in fiscal years 2018, 2017, and 2016, respectively.

Stock-Based Compensation

Compensation cost for stock awards, which include restricted stock units ("RSUs") and performance stock units ("PSUs"), is measured at the fair value on the grant date and recognized as expense, net of estimated forfeitures, over the related service or performance period. 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. We measure the fair value of PSUs using a Monte Carlo valuation model. Compensation cost for RSUs is recognized using the straight-line method and for PSUs is recognized using the accelerated method.

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, 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 in 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 in active markets. Our Level 1 non-derivative investments primarily include U.S. government securities, common and preferred stock, and 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. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, foreign government bonds, mortgage- and asset-backed securities, commercial paper, certificates of deposit, and U.S. agency securities. 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 and liabilities 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 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 in 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.

Inventories

Inventories are stated at average cost, subject to the lower of cost or net realizable value. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. Net realizable value is the estimated selling price less estimated costs of completion, disposal, and transportation. 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.

Leases

We determine if an arrangement is a lease at inception. Operating leases are included in operating lease right-of-use ("ROU") assets, other current liabilities, and operating lease liabilities in our consolidated balance sheets. Finance leases are included in property and equipment, other current liabilities, and other long-term liabilities in our consolidated balance sheets.

ROU assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. We use the implicit rate when readily determinable. The operating lease ROU asset also includes any lease payments made and excludes lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

We have lease agreements with lease and non-lease components, which are generally accounted for separately. For certain equipment leases, such as vehicles, we account for the lease and non-lease components as a single lease component. Additionally, for certain equipment leases, we apply a portfolio approach to effectively account for the operating lease ROU assets and liabilities.

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 20 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 Tax Legislation

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business. Refer to Note 13 – Income Taxes for further discussion.

As a result of the TCJA, we have recast certain prior period income tax liabilities in our consolidated balance sheets to conform to the current period presentation. Previously reported balances were impacted as follows:

(In millions)	**As Previously Reported**	**As Adjusted**
Balance Sheets		**June 30, 2017**
Long-term income taxes	$ 0	$ 13,485
Other long-term liabilities	17,034	3,549

These adjustments had no impact in our consolidated income statements or net cash from or used in operating, financing, or investing in our consolidated cash flows statements.

Recent Accounting Guidance

Recently Adopted Accounting Guidance

<u>Comprehensive Income – Reclassification of Certain Tax Effects</u>

In February 2018, the Financial Accounting Standards Board ("FASB") issued new guidance to allow a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings for stranded tax effects resulting from the TCJA. In the second quarter of fiscal year 2018, we remeasured our deferred taxes related to unrealized gains on our investment balances using the reduced tax rate. As required by GAAP, we recognized the net tax benefit in the provision for income taxes in our consolidated income statements, even though the deferred taxes were initially recognized in AOCI, which resulted in stranded tax effects. We elected to early adopt the standard effective April 1, 2018 and reclassified a $42 million net tax benefit from AOCI to retained earnings in our consolidated balance sheets. Adoption of the standard had no impact to our consolidated income statements or cash flows 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 ROU assets and lease liabilities on the balance sheet. Most prominent among the changes in the standard is the recognition of ROU assets and lease liabilities by lessees for those leases classified as operating leases. Under the 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 are also required to recognize and measure leases existing at, or entered into after, the beginning of the earliest comparative period presented using a modified retrospective approach, with certain practical expedients available.

We elected to early adopt the standard effective July 1, 2017 concurrent with our adoption of the new standard related to revenue recognition. We elected the available practical expedients and implemented internal controls and key system functionality to enable the preparation of financial information on adoption.

The standard had a material impact in our consolidated balance sheets, but did not have an impact in our consolidated income statements. The most significant impact was the recognition of ROU assets and lease liabilities for operating leases, while our accounting for finance leases remained substantially unchanged. Adoption of the standard required us to restate certain previously reported results, including the recognition of additional ROU assets and lease liabilities for operating leases. Refer to Impacts to Previously Reported Results below for the impact of adoption of the standard in our consolidated financial statements.

Revenue from Contracts with Customers

In May 2014, the FASB issued a new standard related to revenue recognition. Under the standard, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration 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.

We elected to early adopt the standard effective July 1, 2017, using the full retrospective method, which required us to restate each prior reporting period presented. We implemented internal controls and key system functionality to enable the preparation of financial information on adoption.

The most significant impact of the standard relates to our accounting for software license revenue. Specifically, for Windows 10, we recognize revenue predominantly at the time of billing and delivery rather than ratably over the life of the related device. For certain multi-year commercial software subscriptions that include both distinct software licenses and SA, we recognize license revenue at the time of contract execution rather than over the subscription period. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard depends on contract-specific terms and in some instances may vary from recognition at the time of billing. Revenue recognition related to our hardware, cloud offerings (such as Office 365), LinkedIn, and professional services remains substantially unchanged.

Adoption of the standard using the full retrospective method required us to restate certain previously reported results, including the recognition of additional revenue and an increase in the provision for income taxes, primarily due to the net change in Windows 10 revenue recognition. In addition, adoption of the standard resulted in an increase in accounts receivable and other current and long-term assets, driven by unbilled receivables from upfront recognition of revenue for certain multi-year commercial software subscriptions that include both distinct software licenses and SA; a reduction of unearned revenue, driven by the upfront recognition of license revenue from Windows 10 and certain multi-year commercial software subscriptions; and an increase in deferred income taxes, driven by the upfront recognition of revenue. Refer to Impacts to Previously Reported Results below for the impact of adoption of the standard in our consolidated financial statements.

Impacts to Previously Reported Results

Adoption of the standards related to revenue recognition and leases impacted our previously reported results as follows:

(In millions, except per share amounts)	As Previously Reported	New Revenue Standard Adjustment	As Restated
Income Statements			
Year Ended June 30, 2017			
Revenue	$ 89,950	$ 6,621	$ 96,571
Provision for income taxes	1,945	2,467	4,412
Net income	21,204	4,285	25,489
Diluted earnings per share	2.71	0.54	3.25
Year Ended June 30, 2016			
Revenue	$ 85,320	$ 5,834	$ 91,154
Provision for income taxes	2,953	2,147	5,100
Net income	16,798	3,741	20,539
Diluted earnings per share	2.10	0.46	2.56

(In millions)	As Previously Reported	New Revenue Standard Adjustment	New Lease Standard Adjustment	As Restated
Balance Sheets				
June 30, 2017				
Accounts receivable, net of allowance for doubtful accounts	$ 19,792	$ 2,639	$ 0	$ 22,431
Operating lease right-of-use assets	0	0	6,555	6,555
Other current and long-term assets	11,147	32	0	11,179
Unearned revenue	44,479	(17,823)	0	26,656
Deferred income taxes	531	5,203	0	5,734
Operating lease liabilities	0	0	5,372	5,372
Other current and long-term liabilities	23,464	(26)	1,183	24,621
Stockholders’ equity	72,394	15,317	0	87,711

Adoption of the standards related to revenue recognition and leases had no impact to cash from or used in operating, financing, or investing in our consolidated cash flows statements.

Recent Accounting Guidance Not Yet Adopted

Financial Instruments – Targeted Improvements to Accounting for Hedging Activities

In August 2017, the FASB issued new guidance related to accounting for hedging activities. This guidance expands strategies that qualify for hedge accounting, changes how many hedging relationships are presented in the financial statements, and simplifies the application of hedge accounting in certain situations. The standard will be effective for us beginning July 1, 2019, with early adoption permitted for any interim or annual period before the effective date. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. We are currently evaluating the impact of this standard in our consolidated financial statements, including accounting policies, processes, and systems.

Income Taxes – Intra-Entity Asset Transfers

In October 2016, the FASB issued new guidance requiring an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than when the asset has been sold to an outside party. This guidance is effective for us beginning July 1, 2018, with early adoption permitted beginning July 1, 2017. We plan to adopt the guidance effective July 1, 2018. Adoption of the guidance will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date. We currently expect a net cumulative-effect adjustment of approximately $550 million, which will reverse the deferral of income tax consequences from past intra-entity transfers involving assets other than inventory and new deferred tax assets for amounts not recognized under current GAAP, partially offset by a U.S. deferred tax liability related to global intangible low-taxed income ("GILTI"). Adoption of the standard is expected to result in an increase in long-term deferred tax assets of $2.8 billion, an increase in long-term deferred tax liabilities of $2.1 billion, and a reduction to other current assets of $150 million. As a result of the TCJA, we are continuing to evaluate the impact of this standard in our consolidated financial statements, including accounting policies, processes, and systems.

Financial Instruments – Credit Losses

In June 2016, the FASB issued a new standard to replace the incurred loss impairment methodology under 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. We will be required to use a forward-looking expected credit loss model for accounts receivables, loans, and other financial instruments. 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 standard will be effective for us beginning July 1, 2020, with early adoption permitted beginning July 1, 2019. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the effective date to align our credit loss methodology with the new standard. We are currently evaluating the impact of this standard in our consolidated financial statements, including accounting policies, processes, and systems.

Financial Instruments – Recognition, Measurement, Presentation, and Disclosure

In January 2016, the FASB issued a new standard related to certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the changes in the standard 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. Under the standard, equity investments that do not have a readily determinable fair value are eligible for the measurement alternative. Using the measurement alternative, investments without readily determinable fair values will be valued at cost, with adjustments for changes in price or impairments reflected through net income.

The standard will be effective for us beginning July 1, 2018. Adoption of the standard will be applied using a modified retrospective approach through a cumulative-effect adjustment from AOCI to retained earnings as of the effective date. A cumulative-effect adjustment will capture any previously held unrealized gains and losses held in AOCI related to our equity investments carried at fair value as well as the impact of recording the fair value of certain equity investments carried at cost. In preparation for adoption of this standard, we have implemented internal controls to align with the new standard and have concluded that we will elect the measurement alternative for equity investments that do not have readily determinable fair values.

The impact in our consolidated balance sheets upon adoption will not be material. Adoption of the standard will have no impact to cash from or used in operating, financing or investing in our consolidated cash flows statements.

NOTE 2 — EARNINGS PER SHARE

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

The components of basic and diluted EPS were as follows:

(In millions, except earnings per share)

Year Ended June 30,	**2018**	**2017**	**2016**
Net income available for common shareholders (A)	**$ 16,571**	$ 25,489	$ 20,539
Weighted average outstanding shares of common stock (B)	**7,700**	7,746	7,925
Dilutive effect of stock-based awards	**94**	86	88
Common stock and common stock equivalents (C)	**7,794**	7,832	8,013
Earnings Per Share			
Basic (A/B)	**$ 2.15**	$ 3.29	$ 2.59
Diluted (A/C)	**$ 2.13**	$ 3.25	$ 2.56

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,	**2018**	**2017**	**2016**
Dividends and interest income	**$ 2,214**	$ 1,387	$ 903
Interest expense	**(2,733)**	(2,222)	(1,243)
Net recognized gains on investments	**2,399**	2,583	668
Net losses on derivatives	**(187)**	(510)	(443)
Net losses on foreign currency remeasurements	**(218)**	(111)	(129)
Other, net	**(59)**	(251)	(195)
Total	**$ 1,416**	$ 876	$ (439)

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

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Other-than-temporary impairments of investments	**$ (47)**	$ (55)	$ (322)
Realized gains from sales of available-for-sale securities	**3,478**	3,064	1,376
Realized losses from sales of available-for-sale securities	**(1,032)**	(426)	(386)
Total	**$ 2,399**	$ 2,583	$ 668

NOTE 4 — INVESTMENTS

Investment Components

The components of investments, including associated derivatives, were as follows:

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2018							
Cash	**$ 3,942**	**$ 0**	**$ 0**	**$ 3,942**	**$ 3,942**	**$ 0**	**$ 0**
Mutual funds	**246**	**0**	**0**	**246**	**246**	**0**	**0**
Commercial paper	**2,513**	**0**	**0**	**2,513**	**2,215**	**298**	**0**
Certificates of deposit	**2,058**	**0**	**0**	**2,058**	**1,865**	**193**	**0**
U.S. government and agency securities	**109,862**	**62**	**(1,167)**	**108,757**	**3,678**	**105,079**	**0**
Foreign government bonds	**5,182**	**1**	**(10)**	**5,173**	**0**	**5,173**	**0**
Mortgage- and asset-backed securities	**3,868**	**4**	**(13)**	**3,859**	**0**	**3,859**	**0**
Corporate notes and bonds	**6,947**	**21**	**(56)**	**6,912**	**0**	**6,912**	**0**
Municipal securities	**271**	**37**	**(1)**	**307**	**0**	**307**	**0**
Common and preferred stock	**1,220**	**95**	**(10)**	**1,305**	**0**	**0**	**1,305**
Other investments	**558**	**0**	**0**	**558**	**0**	**1**	**557**
Total	**$ 136,667**	**$ 220**	**$ (1,257)**	**$ 135,630**	**$ 11,946**	**$ 121,822**	**$ 1,862**

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2017							
Cash	$ 3,624	$ 0	$ 0	$ 3,624	$ 3,624	$ 0	$ 0
Mutual funds	1,478	0	0	1,478	1,478	0	0
Commercial paper	319	0	0	319	69	250	0
Certificates of deposit	1,358	0	0	1,358	972	386	0
U.S. government and agency securities	112,119	85	(360)	111,844	16	111,828	0
Foreign government bonds	5,276	2	(13)	5,265	1,504	3,761	0
Mortgage- and asset-backed securities	3,921	14	(4)	3,931	0	3,931	0
Corporate notes and bonds	4,786	61	(12)	4,835	0	4,835	0
Municipal securities	284	43	0	327	0	327	0
Common and preferred stock	2,472	3,062	(34)	5,500	0	0	5,500
Other investments	523	0	0	523	0	0	523
Total	$ 136,160	$ 3,267	$ (423)	$ 139,004	$ 7,663	$ 125,318	$ 6,023

As of June 30, 2018 and 2017, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $999 million and $1.1 billion, 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, 2018 and 2017, collateral received under agreements for loaned securities was $1.8 billion and $3.7 billion, respectively, and primarily comprised 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:

	Less than 12 Months		12 Months or Greater			
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2018						
U.S. government and agency securities	**$ 82,352**	**$ (1,064)**	**$ 4,459**	**$ (103)**	**$ 86,811**	**$ (1,167)**
Foreign government bonds	**3,457**	**(7)**	**13**	**(3)**	**3,470**	**(10)**
Mortgage- and asset-backed securities	**2,072**	**(9)**	**96**	**(4)**	**2,168**	**(13)**
Corporate notes and bonds	**3,111**	**(43)**	**301**	**(13)**	**3,412**	**(56)**
Municipal securities	**45**	**(1)**	**0**	**0**	**45**	**(1)**
Common and preferred stock	**75**	**(6)**	**8**	**(4)**	**83**	**(10)**
Total	**$ 91,112**	**$ (1,130)**	**$ 4,877**	**$ (127)**	**$ 95,989**	**$ (1,257)**

	Less than 12 Months		12 Months or Greater			
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2017						
U.S. government and agency securities	$ 87,558	$ (348)	$ 371	$ (12)	$ 87,929	$ (360)
Foreign government bonds	4,006	(2)	23	(11)	4,029	(13)
Mortgage- and asset-backed securities	1,068	(3)	198	(1)	1,266	(4)
Corporate notes and bonds	669	(8)	177	(4)	846	(12)
Common and preferred stock	69	(6)	148	(28)	217	(34)
Total	$ 93,370	$ (367)	$ 917	$ (56)	$ 94,287	$ (423)

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, 2018		
Due in one year or less	$ 31,590	$ 31,451
Due after one year through five years	76,422	75,810
Due after five years through 10 years	21,765	21,396
Due after 10 years	924	922
Total	$ 130,701	$ 129,579

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, 2018 and 2017, the total notional amounts of these foreign exchange contracts sold were $6.1 billion and $8.9 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of June 30, 2018 and 2017, the total notional amounts of these foreign exchange contracts sold were $5.0 billion and $5.1 billion, respectively.

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, 2018, the total notional amounts of these foreign exchange contracts purchased and sold were $9.4 billion and $13.4 billion, respectively. As of June 30, 2017, the total notional amounts of these foreign exchange contracts purchased and sold were $8.8 billion and $10.6 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of June 30, 2018, the total notional amounts of equity contracts purchased and sold for managing market price risk were $49 million and $5 million, respectively. As of June 30, 2017, the total notional amounts of equity contracts purchased and sold for managing market price risk were $1.9 billion and $2.4 billion, respectively, of which $1.6 billion and $1.8 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, 2018, the total notional amounts of fixed-interest rate contracts purchased and sold were $306 million and $390 million, respectively. As of June 30, 2017, the total notional amounts of fixed-interest rate contracts purchased and sold were $233 million and $352 million, respectively.

In addition, we use “To Be Announced” forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of June 30, 2018 and 2017, the total notional derivative amounts of mortgage contracts purchased were $568 million and $567 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, 2018, the total notional amounts of credit contracts purchased and sold were $4 million and $82 million, respectively. As of June 30, 2017, the total notional amounts of credit contracts purchased and sold were $267 million and $63 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, 2018, 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:

	Assets				Liabilities	
(In millions)	**Short-term Investments**	**Other Current Assets**	**Equity and Other Investments**	**Other Long-term Assets**	**Other Current Liabilities**	**Other Long-term Liabilities**
June 30, 2018						
Non-designated Hedge Derivatives						
Foreign exchange contracts	$ 10	$ 221	$ 0	$ 25	$ (193)	$ (4)
Equity contracts	2	0	0	0	(7)	0
Interest rate contracts	11	0	0	0	(2)	0
Credit contracts	0	0	0	0	(1)	0
Total	$ 23	$ 221	$ 0	$ 25	$ (203)	$ (4)
Designated Hedge Derivatives						
Foreign exchange contracts	$ 95	$ 174	$ 0	$ 0	$ 0	$ 0
Equity contracts	0	0	0	0	0	0
Total	$ 95	$ 174	$ 0	$ 0	$ 0	$ 0
Total gross amounts of derivatives	$ 118	$ 395	$ 0	$ 25	$ (203)	$ (4)
Gross derivatives either offset or subject to an enforceable master netting agreement	$ 113	$ 395	$ 0	$ 25	$ (203)	$ (4)
Gross amounts of derivatives offset on the balance sheet	(14)	(135)	0	(3)	150	3
Net amounts presented on the balance sheet	99	260	0	22	(53)	(1)
Gross amounts of derivatives not offset on the balance sheet	0	0	0	0	0	0
Cash collateral received	0	0	0	0	(235)	0
Net amount	$ 99	$ 260	$ 0	$ 22	$ (288)	$ (1)

(In millions)	Short-term Investments	Other Current Assets	Equity and Other Investments	Assets Other Long-term Assets	Other Current Liabilities	Liabilities Other Long-term Liabilities
June 30, 2017						
Non-designated Hedge Derivatives						
Foreign exchange contracts	$ 9	$ 203	$ 0	$ 6	$ (134)	$ (8)
Equity contracts	3	0	0	0	(6)	0
Interest rate contracts	3	0	0	0	(7)	0
Credit contracts	5	0	0	0	(1)	0
Total	$ 20	$ 203	$ 0	$ 6	$ (148)	$ (8)
Designated Hedge Derivatives						
Foreign exchange contracts	$ 80	$ 133	$ 0	$ 0	$ (3)	$ 0
Equity contracts	0	0	67	0	(186)	0
Total	$ 80	$ 133	$ 67	$ 0	$ (189)	$ 0
Total gross amounts of derivatives	$ 100	$ 336	$ 67	$ 6	$ (337)	$ (8)
Gross derivatives either offset or subject to an enforceable master netting agreement	$ 100	$ 336	$ 67	$ 6	$ (334)	$ (8)
Gross amounts of derivatives offset on the balance sheet	(20)	(132)	(67)	(8)	221	7
Net amounts presented on the balance sheet	80	204	0	(2)	(113)	(1)
Gross amounts of derivatives not offset on the balance sheet	0	0	0	0	0	0
Cash collateral received	0	0	0	0	(228)	0
Net amount	$ 80	$ 204	$ 0	$ (2)	$ (341)	$ (1)

Refer to Note 4 – Investments and Note 6 – Fair Value Measurements for further information.

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,	**2018**	**2017**	**2016**
Foreign Exchange Contracts			
Derivatives	**$ 25**	$ 441	$ (797)
Hedged items	**78**	(386)	838
Total amount of ineffectiveness	**$ 103**	$ 55	$ 41
Equity Contracts			
Derivatives	**$ (324)**	$ (74)	$ (76)
Hedged items	**324**	74	76
Total amount of ineffectiveness	**$ 0**	$ 0	$ 0
Amount of equity contracts excluded from effectiveness assessment	**$ 80**	$ (80)	$ (10)

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,		**2018**		**2017**		**2016**
Effective Portion						
Gains recognized in other comprehensive income (net of tax of **$11**, $4, and $24)	**$**	**219**	$	328	$	351
Gains reclassified from accumulated other comprehensive income (loss) into revenue		**185**		555		625
Amount Excluded from Effectiveness Assessment and Ineffective Portion						
Losses recognized in other income (expense), net		**(255)**		(389)		(354)

We estimate that $179 million of net derivative gains included in AOCI as of June 30, 2018 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 2018.

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.

(In millions)

Year Ended June 30,		**2018**		**2017**		**2016**
Foreign exchange contracts	**$**	**(33)**	$	(117)	$	(55)
Equity contracts		**(87)**		(114)		(21)
Interest rate contracts		**(15)**		14		10
Credit contracts		**(2)**		5		(1)
Other contracts		**0**		(22)		(87)
Total	**$**	**(137)**	$	(234)	$	(154)

NOTE 6 — FAIR VALUE MEASUREMENTS

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

The following tables present the fair value of our financial instruments that are measured at fair value on a recurring basis:

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2018						
Assets						
Mutual funds	**$ 246**	**$ 0**	**$ 0**	**$ 246**	**$ 0**	**$ 246**
Commercial paper	**0**	**2,513**	**0**	**2,513**	**0**	**2,513**
Certificates of deposit	**0**	**2,058**	**0**	**2,058**	**0**	**2,058**
U.S. government and agency securities	**107,015**	**1,742**	**0**	**108,757**	**0**	**108,757**
Foreign government bonds	**22**	**5,054**	**0**	**5,076**	**0**	**5,076**
Mortgage- and asset-backed securities	**0**	**3,855**	**0**	**3,855**	**0**	**3,855**
Corporate notes and bonds	**0**	**6,894**	**15**	**6,909**	**0**	**6,909**
Municipal securities	**0**	**307**	**0**	**307**	**0**	**307**
Common and preferred stock	**287**	**0**	**18**	**305**	**0**	**305**
Derivatives	**1**	**535**	**2**	**538**	**(152)**	**386**
Total	**$ 107,571**	**$ 22,958**	**$ 35**	**$ 130,564**	**$ (152)**	**$ 130,412**
Liabilities						
Derivatives and other	**$ 1**	**$ 206**	**$ 0**	**$ 207**	**$ (153)**	**$ 54**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2017						
Assets						
Mutual funds	$ 1,478	$ 0	$ 0	$ 1,478	$ 0	$ 1,478
Commercial paper	0	319	0	319	0	319
Certificates of deposit	0	1,358	0	1,358	0	1,358
U.S. government and agency securities	109,228	2,616	0	111,844	0	111,844
Foreign government bonds	0	5,187	0	5,187	0	5,187
Mortgage- and asset-backed securities	0	3,934	0	3,934	0	3,934
Corporate notes and bonds	0	4,829	1	4,830	0	4,830
Municipal securities	0	327	0	327	0	327
Common and preferred stock	2,414	1,994	18	4,426	0	4,426
Derivatives	1	508	0	509	(227)	282
Total	$ 113,121	$ 21,072	$ 19	$ 134,212	$ (227)	$ 133,985
Liabilities						
Derivatives and other	$ 0	$ 345	$ 39	$ 384	$ (228)	$ 156

(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 the balance sheet presentation of these same assets in Note 4 – Investments.

(In millions)

June 30,	**2018**	**2017**
Net fair value of assets measured at fair value on a recurring basis	**$ 130,412**	$ 133,985
Cash	**3,942**	3,624
Common and preferred stock measured at fair value on a nonrecurring basis	**999**	1,073
Other investments measured at fair value on a nonrecurring basis	**557**	523
Less derivative net assets classified as other current and long-term assets	**(282)**	(202)
Other	**2**	1
Recorded basis of investment components	**$ 135,630**	$ 139,004

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

During fiscal year 2018 and 2017, 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,	**2018**	**2017**
Raw materials	**$ 655**	$ 797
Work in process	**54**	145
Finished goods	**1,953**	1,239
Total	**$ 2,662**	$ 2,181

NOTE 8 — PROPERTY AND EQUIPMENT

The components of property and equipment were as follows:

(In millions)

June 30,	**2018**	**2017**
Land	**$ 1,254**	$ 1,107
Buildings and improvements	**20,604**	16,284
Leasehold improvements	**4,735**	5,064
Computer equipment and software	**27,633**	21,414
Furniture and equipment	**4,457**	4,044
Total, at cost	**58,683**	47,913
Accumulated depreciation	**(29,223)**	(24,179)
Total, net	**$ 29,460**	$ 23,734

During fiscal years 2018, 2017, and 2016, depreciation expense was $7.7 billion, $6.1 billion, and $4.9 billion, respectively. We have committed $1.9 billion for the construction of new buildings, building improvements, and leasehold improvements as of June 30, 2018.

NOTE 9 — BUSINESS COMBINATIONS

LinkedIn Corporation

On December 8, 2016, we completed our acquisition of all issued and outstanding shares of LinkedIn Corporation, the world's largest professional network on the Internet, for a total purchase price of $27.0 billion. The purchase price consisted primarily of cash of $26.9 billion. The acquisition is expected to accelerate the growth of LinkedIn, Office 365, and Dynamics 365. The financial results of LinkedIn have been included in our consolidated financial statements since the date of the acquisition.

The allocation of the purchase price to goodwill was completed as of June 30, 2017.

The major classes of assets and liabilities to which we allocated the purchase price were as follows:

(In millions)	
Cash and cash equivalents	$ 1,328
Short-term investments	2,110
Other current assets	697
Property and equipment	1,529
Intangible assets	7,887
Goodwill (a)	16,803
Short-term debt (b)	(1,323)
Other current liabilities	(1,117)
Deferred income taxes	(774)
Other	(131)
Total purchase price	$ 27,009

(a) *Goodwill was assigned to our Productivity and Business Processes segment. The goodwill was primarily attributed to increased synergies that are expected to be achieved from the integration of LinkedIn. None of the goodwill is expected to be deductible for income tax purposes.*

(b) *Convertible senior notes issued by LinkedIn on November 12, 2014, substantially all of which were redeemed after our acquisition of LinkedIn. The remaining $18 million of notes are not redeemable and are included in long-term debt in our consolidated balance sheets. Refer to Note 12 – Debt for further information.*

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

(In millions)	Amount	Weighted Average Life
Customer-related	$ 3,607	7 years
Marketing-related (trade names)	2,148	20 years
Technology-based	2,109	3 years
Contract-based	23	5 years
Fair value of intangible assets acquired	$ 7,887	9 years

Our consolidated income statements include the following revenue and operating loss attributable to LinkedIn since the date of acquisition:

(In millions)	
Year Ended June 30,	2017
Revenue	$ 2,271
Operating loss	(924)

Following are the supplemental consolidated financial results of Microsoft Corporation on an unaudited pro forma basis, as if the acquisition had been consummated on July 1, 2015:

(In millions, except earnings per share)

Year Ended June 30,	**2017**	**2016**
Revenue	**$ 98,291**	$ 94,490
Net income	**25,179**	19,128
Diluted earnings per share	**3.21**	2.38

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 related to purchase accounting, primarily amortization of intangible assets. Acquisition costs and other nonrecurring charges were immaterial and are included in the earliest period presented.

GitHub Inc.

On June 4, 2018, we entered into a definitive agreement to acquire GitHub Inc. ("GitHub") for $7.5 billion in an all-stock transaction. We expect the acquisition will close by the end of the calendar year, subject to approval by GitHub's shareholders, satisfaction of certain regulatory approvals, and other customary closing conditions. GitHub will be included in our consolidated results of operations as of the date of acquisition.

Other

During fiscal year 2018, we completed nine acquisitions for total consideration of $948 million, substantially all of which was paid in cash. These entities have been included in our consolidated results of operations since their respective acquisition dates. Pro forma results of operations for these acquisitions have not been presented because the effects of these business combinations, individually and in aggregate, were not material to our consolidated results of operations.

NOTE 10 — GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	**June 30, 2016**	**Acquisitions**	**Other**	**June 30, 2017**	**Acquisitions**	**Other**	**June 30, 2018**
Productivity and Business Processes	$ 6,678	$ 17,072 (a)	$ (11)	$ 23,739	**$ 72**	**$ 12**	**$ 23,823**
Intelligent Cloud	5,467	49	39	5,555	**164**	**(16)**	**5,703**
More Personal Computing	5,727	115	(14)	5,828	**394**	**(65)**	**6,157**
Total	$ 17,872	$ 17,236	$ 14	$ 35,122	**$ 630**	**$ (69)**	**$ 35,683**

(a) *Includes goodwill related to LinkedIn and other acquisitions. Refer to Note 9 – Business Combinations for further information.*

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 change in the amounts allocated to goodwill during the periods in which the adjustments are determined.

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 segments due to reorganizations, as applicable.

As of June 30, 2018 and 2017, accumulated goodwill impairment was $11.3 billion.

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, 2018, May 1, 2017, or May 1, 2016 tests.

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,			**2018**			**2017**
Technology-based	**$ 7,220**	**$ (5,018)**	**$ 2,202**	$ 7,765	$ (4,318)	$ 3,447
Customer-related	**4,031**	**(1,205)**	**2,826**	4,045	(692)	3,353
Marketing-related	**4,006**	**(1,071)**	**2,935**	4,016	(829)	3,187
Contract-based	**679**	**(589)**	**90**	841	(722)	119
Total	**$ 15,936**	**$ (7,883)**	**$ 8,053**	$ 16,667	$ (6,561)	$ 10,106

No material impairments of intangible assets were identified during fiscal year 2018 or 2017.

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.

These intangible assets impairment charges were included in impairment and restructuring expenses in 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,	**2018**		**2017**	
Technology-based	**$ 178**	**4 years**	$ 2,265	2 years
Marketing-related	**14**	**5 years**	2,148	19 years
Contract-based	**14**	**4 years**	63	6 years
Customer-related	**13**	**5 years**	3,607	7 years
Total	**$ 219**	**5 years**	$ 8,083	9 years

Intangible assets amortization expense was $2.2 billion, $1.7 billion, and $978 million for fiscal years 2018, 2017, and 2016, respectively. Amortization of capitalized software was $54 million, $55 million, and $69 million for fiscal years 2018, 2017, and 2016, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held as of June 30, 2018:

(In millions)		
Year Ending June 30,		
2019	$	1,785
2020		1,260
2021		1,043
2022		949
2023		806
Thereafter		2,210
Total	$	8,053

NOTE 12 — DEBT

Short-term Debt

As of June 30, 2018, we had no commercial paper issued and outstanding. As of June 30, 2017, we had $9.1 billion of commercial paper issued and outstanding, with a weighted average interest rate of 1.01% and maturities ranging from 25 days to 264 days. The estimated fair value of this commercial paper approximates its carrying value.

We have two $5.0 billion credit facilities that expire on October 30, 2018 and October 31, 2022, respectively. These credit facilities serve as a back-up for our commercial paper program. As of June 30, 2018, 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, 2018, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $76.2 billion and $77.5 billion, respectively. As of June 30, 2017, the total carrying value and estimated fair value of our long-term debt, including the current portion, were $77.1 billion and $80.3 billion, respectively. These estimated fair values are based on Level 2 inputs.

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

(In millions, except interest rates)	Face Value June 30, 2018	Face Value June 30, 2017	Stated Interest Rate	Effective Interest Rate
Notes				
November 15, 2017	**$ 0**	$ 600	**0.875%**	**1.084%**
May 1, 2018	**0**	450	**1.000%**	**1.106%**
November 3, 2018	**1,750**	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%**
August 8, 2019	**2,500**	2,500	**1.100%**	**1.203%**
November 1, 2019	**18**	18	**0.500%**	**0.500%**
February 6, 2020	**1,500**	1,500	**1.850%**	**1.952%**
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	**2,250**	2,250	**2.000%**	**2.093%**
February 8, 2021	**500**	500	**4.000%**	**4.082%**
August 8, 2021	**2,750**	2,750	**1.550%**	**1.642%**
December 6, 2021 (a)	**2,044**	1,996	**2.125%**	**2.233%**
February 6, 2022	**1,750**	1,750	**2.400%**	**2.520%**
February 12, 2022	**1,500**	1,500	**2.375%**	**2.466%**
November 3, 2022	**1,000**	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%**
August 8, 2023	**1,500**	1,500	**2.000%**	**2.101%**
December 15, 2023	**1,500**	1,500	**3.625%**	**3.726%**
February 6, 2024	**2,250**	2,250	**2.875%**	**3.041%**
February 12, 2025	**2,250**	2,250	**2.700%**	**2.772%**
November 3, 2025	**3,000**	3,000	**3.125%**	**3.176%**
August 8, 2026	**4,000**	4,000	**2.400%**	**2.464%**
February 6, 2027	**4,000**	4,000	**3.300%**	**3.383%**
December 6, 2028 (a)	**2,044**	1,996	**3.125%**	**3.218%**
May 2, 2033 (a)	**642**	627	**2.625%**	**2.690%**
February 12, 2035	**1,500**	1,500	**3.500%**	**3.604%**
November 3, 2035	**1,000**	1,000	**4.200%**	**4.260%**
August 8, 2036	**2,250**	2,250	**3.450%**	**3.510%**
February 6, 2037	**2,500**	2,500	**4.100%**	**4.152%**
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	**3,000**	3,000	**4.450%**	**4.492%**
August 8, 2046	**4,500**	4,500	**3.700%**	**3.743%**
February 6, 2047	**3,000**	3,000	**4.250%**	**4.287%**
February 12, 2055	**2,250**	2,250	**4.000%**	**4.063%**
November 3, 2055	**1,000**	1,000	**4.750%**	**4.782%**
August 8, 2056	**2,250**	2,250	**3.950%**	**4.033%**
February 6, 2057	**2,000**	2,000	**4.500%**	**4.528%**
Total	**$ 76,898**	$ 77,837		

(a) *Euro-denominated debt securities.*

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 2018, 2017, and 2016 was $2.4 billion, $1.6 billion, and $1.1 billion, respectively. As of June 30, 2018 and 2017, the aggregate debt issuance costs and unamortized discount associated with our long-term debt, including the current portion, were $658 million and $715 million, respectively.

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

(In millions)	
Year Ending June 30,	
2019	$ 4,000
2020	5,518
2021	3,750
2022	8,044
2023	2,750
Thereafter	52,836
Total	$ 76,898

NOTE 13 — INCOME TAXES

Recent Tax Legislation

On December 22, 2017, the TCJA was enacted into law, which significantly changes existing U.S. tax law and includes numerous provisions that affect our business, such as imposing a one-time transition tax on deemed repatriation of deferred foreign income, reducing the U.S. federal statutory tax rate, and adopting a territorial tax system. The TCJA required us to incur a one-time transition tax on deferred foreign income not previously subject to U.S. income tax at a rate of 15.5% for foreign cash and certain other net current assets, and 8% on the remaining income. The TCJA also reduced the U.S. federal statutory tax rate from 35% to 21% effective January 1, 2018. For fiscal year 2018, our blended U.S. federal statutory tax rate is 28.1%. This is the result of using the tax rate of 35% for the first and second quarter of fiscal year 2018 and the reduced tax rate of 21% for the third and fourth quarter of fiscal year 2018. The TCJA includes a provision to tax global intangible low-taxed income ("GILTI") of foreign subsidiaries and a base erosion anti-abuse tax ("BEAT") measure that taxes certain payments between a U.S. corporation and its foreign subsidiaries. The GILTI and BEAT provisions of the TCJA will be effective for us beginning July 1, 2018.

The TCJA was effective in the second quarter of fiscal year 2018. As of June 30, 2018, we have not completed our accounting for the estimated tax effects of the TCJA. During fiscal year 2018, we recorded a provisional net charge of $13.7 billion related to the TCJA based on reasonable estimates for those tax effects. Due to the timing of the enactment and the complexity in applying the provisions of the TCJA, the provisional net charge is subject to revisions as we continue to complete our analysis of the TCJA, collect and prepare necessary data, and interpret any additional guidance issued by the U.S. Treasury Department, Internal Revenue Service ("IRS"), FASB, and other standard-setting and regulatory bodies. Adjustments may materially impact our provision for income taxes and effective tax rate in the period in which the adjustments are made. Our accounting for the estimated tax effects of the TCJA will be completed during the measurement period, which is not expected to extend beyond one year from the enactment date. The impacts of our estimates are described further below.

During fiscal year 2018, we recorded an estimated net charge of $13.7 billion related to the TCJA, due to the impact of the one-time transition tax on the deemed repatriation of deferred foreign income of $17.9 billion, offset in part by the impact of changes in the tax rate of $4.2 billion, primarily on deferred tax assets and liabilities.

We recorded an estimated $17.9 billion charge in fiscal year 2018 related to the transition tax, which was included in the provision for income taxes in our consolidated income statements and income taxes in our consolidated balance sheets. We have not yet completed our accounting for the transition tax as our analysis of deferred foreign income is not complete. To calculate the transition tax, we estimated our deferred foreign income for fiscal year 2018 because these tax returns are not complete or due. Fiscal year 2018 taxable income will be known once the respective tax returns are completed and filed. In addition, U.S. and foreign audit settlements may significantly impact the estimated transition tax. The impact of the U.S. and foreign audits on the transition tax will be known as the audits are concluded.

In addition, we recorded an estimated $4.2 billion benefit in fiscal year 2018 from the impact of changes in the tax rate, primarily on deferred tax assets and liabilities, which was included in provision for income taxes in our consolidated income statements and deferred income taxes and long-term income taxes in our consolidated balance sheets. We remeasured our deferred taxes to reflect the reduced rate that will apply when these deferred taxes are settled or realized in future periods.

The TCJA subjects a U.S. corporation to tax on its GILTI. Due to the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the TCJA and the application of GAAP. Under GAAP, we can make an accounting policy election to either treat taxes due on the GILTI inclusion as a current period expense or factor such amounts into our measurement of deferred taxes. We elected the deferred method, and the corresponding deferred tax assets and liabilities are included in the table of deferred income tax assets and liabilities below.

On August 1, 2018, the Internal Revenue Service published on its website proposed regulations relating to the transition tax imposed by the TCJA. Once published in the Federal Register, the proposed regulations are subject to a 60-day comment period. Final regulations are expected to be issued after consideration of comments. We are currently evaluating the impact of the proposed regulations.

Provision for Income Taxes

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

(In millions)

Year Ended June 30,	2018	2017	2016
Current Taxes			
U.S. federal	**$ 19,764**	$ 2,739	$ 545
U.S. state and local	**934**	30	136
Foreign	**4,348**	2,472	1,940
Current taxes	**$ 25,046**	$ 5,241	$ 2,621
Deferred Taxes			
U.S. federal	**$ (4,292)**	$ (554)	$ 1,919
U.S. state and local	**(458)**	269	111
Foreign	**(393)**	(544)	449
Deferred taxes	**$ (5,143)**	$ (829)	$ 2,479
Provision for income taxes	**$ 19,903**	$ 4,412	$ 5,100

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

(In millions)

Year Ended June 30,	2018	2017	2016
U.S.	**$ 11,527**	$ 6,843	$ 5,125
Foreign	**24,947**	23,058	20,514
Income before income taxes	**$ 36,474**	$ 29,901	$ 25,639

Effective Tax Rate

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,	2018	2017	2016
Federal statutory rate	**28.1%**	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	**(7.8)%**	(11.6)%	(14.5)%
Impacts of TCJA	**37.7%**	0%	0%
Phone business losses	**0%**	(5.7)%	1.0%
Excess tax benefits relating to stock-based compensation	**(2.5)%**	(2.1)%	(1.6)%
Interest, net	**1.2%**	1.4%	0.9%
Other reconciling items, net	**(2.1)%**	(2.2)%	(0.9)%
Effective rate	**54.6%**	14.8%	19.9%

The increase from the federal statutory rate in fiscal year 2018 is primarily due to the net charge related to the enactment of the TCJA in the second quarter of fiscal year 2018, offset in part by earnings taxed at lower rates in foreign jurisdictions. The decrease from the federal statutory rate in fiscal year 2017 and 2016 is primarily due to earnings taxed at lower rates in foreign jurisdictions. Our foreign regional operating centers in Ireland, Singapore and Puerto Rico, which are taxed at rates lower than the U.S. rate, generated 87%, 76%, and 91% of our foreign income before tax in fiscal years 2018, 2017, and 2016, respectively. Other reconciling items, net consists primarily of tax credits, U.S. state income taxes, and domestic production activities deduction. In fiscal years 2018, 2017, and 2016, there were no individually significant other reconciling items.

The increase in our effective tax rate for fiscal year 2018 compared to fiscal year 2017 was primarily due to the net charge related to the enactment of the TCJA and the realization of tax benefits attributable to previous Phone business losses in fiscal year 2017. The decrease in our effective tax rate for fiscal year 2017 compared to fiscal year 2016 was primarily due to the realization of tax benefits attributable to previous Phone business losses, offset in part by changes in the mix of our income before income taxes between the U.S. and foreign countries.

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

(In millions)		
June 30,	**2018**	**2017**
Deferred Income Tax Assets		
Stock-based compensation expense	**$ 460**	$ 777
Accruals, reserves, and other expenses	**1,832**	1,859
Loss and credit carryforwards	**3,369**	4,809
Depreciation and amortization	**351**	53
Other	**56**	255
Deferred income tax assets	**6,068**	7,753
Less valuation allowance	**(3,186)**	(3,310)
Deferred income tax assets, net of valuation allowance	**$ 2,882**	$ 4,443
Deferred Income Tax Liabilities		
Foreign earnings	**$ 0**	$ (1,134)
Unrealized gain on investments and debt	**0**	(1,384)
Unearned revenue	**(639)**	(5,760)
Depreciation and amortization	**(1,103)**	(1,630)
Other	**(312)**	(21)
Deferred income tax liabilities	**$ (2,054)**	$ (9,929)
Net deferred income tax assets (liabilities)	**$ 828**	$ (5,486)
Reported As		
Other long-term assets	**$ 1,369**	$ 248
Long-term deferred income tax liabilities	**(541)**	(5,734)
Net deferred income tax assets (liabilities)	**$ 828**	$ (5,486)

We recorded a deferred tax liability of $7.4 billion related to the recognition of revenue as part of the adoption of the new revenue standard.

As of June 30, 2018, we had federal, state and foreign net operating loss carryforwards of $257 million, $1.4 billion and $11.4 billion, respectively. The federal and state net operating loss carryforwards will expire in various years from fiscal 2019 through 2038, if not utilized. The majority of our foreign net operating loss carryforwards do not expire. Certain acquired net operating loss carryforwards are subject to an annual limitation, but are expected to be realized with the exception of those which have a valuation allowance.

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 paid or recovered.

Income taxes paid, net of refunds, were $5.5 billion, $2.4 billion, and $3.9 billion in fiscal years 2018, 2017, and 2016, respectively.

Uncertain Tax Positions

Unrecognized tax benefits as of June 30, 2018, 2017, and 2016, were $12.0 billion, $11.7 billion, and $10.2 billion, respectively, and were included in long-term income taxes in our consolidated balance sheets. If recognized, these tax benefits would affect our effective tax rates for fiscal years 2018, 2017, and 2016, by $11.3 billion, $10.2 billion, and $8.8 billion, respectively.

As of June 30, 2018, 2017, and 2016, we had accrued interest expense related to uncertain tax positions of $3.0 billion, $2.3 billion, and $1.9 billion, respectively, net of income tax benefits. Interest expense on unrecognized tax benefits, net of tax effects, was $688 million, $399 million, and $163 million in fiscal years 2018, 2017, and 2016, 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,	**2018**	**2017**	**2016**
Balance, beginning of year	**$ 11,737**	$ 10,164	$ 9,599
Decreases related to settlements	**(193)**	(4)	(201)
Increases for tax positions related to the current year	**1,445**	1,277	1,086
Increases for tax positions related to prior years	**151**	397	115
Decreases for tax positions related to prior years	**(1,176)**	(49)	(317)
Decreases due to lapsed statutes of limitations	**(3)**	(48)	(118)
Balance, end of year	**$ 11,961**	$ 11,737	$ 10,164

While we settled a portion of the IRS audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, and 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 the second quarter of fiscal year 2018, we settled a portion of the IRS audit for tax years 2010 to 2013. We continue to be subject to examination by the IRS for tax years 2010 to 2017. 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, 2018, the primary unresolved issue relates to transfer pricing, which could have a significant impact in 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 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 2017, some of which are currently under audit by local tax authorities. The resolution of each of these audits is not expected to be material to our consolidated financial statements.

NOTE 14 — RESTRUCTURING CHARGES

2016 Restructuring

In the fourth quarter of fiscal year 2016, management approved restructuring plans that resulted in approximately 4,700 job eliminations in fiscal year 2017, primarily across our smartphone hardware business and global sales. In fiscal year 2016, we incurred restructuring charges of $501 million in connection with the 2016 restructuring plans, including severance expenses and other reorganization costs. The actions associated with these restructuring plans were completed as of June 30, 2017.

2017 Restructuring

In June 2017, management approved a sales and marketing restructuring plan. In fiscal year 2017, we recorded employee severance expenses of $306 million primarily related to this sales and marketing restructuring plan. The actions associated with this restructuring plan were completed as of June 30, 2018.

NOTE 15 — UNEARNED REVENUE

Unearned revenue by segment was as follows:

(In millions)

June 30,	2018	2017
Productivity and Business Processes	**$ 14,864**	$ 12,692
Intelligent Cloud	**14,706**	11,152
More Personal Computing	**3,150**	2,812
Total	**$ 32,720**	$ 26,656

The opening balance of unearned revenue was $22.2 billion as of July 1, 2016.

Changes in unearned revenue were as follows:

(In millions)

Year Ended June 30, 2018	
Balance, beginning of period	**$ 26,656**
Deferral of revenue	**61,142**
Recognition of unearned revenue	**(55,078)**
Balance, end of period	**$ 32,720**

Revenue allocated to remaining performance obligations represents contracted revenue that has not yet been recognized (“contracted not recognized revenue”), which includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. Contracted not recognized revenue was $73 billion as of June 30, 2018, of which we expect to recognize approximately 60% of the revenue over the next 12 months and the remainder thereafter.

NOTE 16 — LEASES

We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which include options to extend the leases for up to 5 years, and some of which include options to terminate the leases within 1 year.

The components of lease expense were as follows:

(In millions)

Year Ended June 30,	2018	2017	2016
Operating lease cost	**$ 1,585**	$ 1,412	$ 936
Finance lease cost:			
Amortization of right-of-use assets	**$ 243**	$ 104	$ 28
Interest on lease liabilities	**175**	68	28
Total finance lease cost	**$ 418**	$ 172	$ 56

Supplemental cash flow information related to leases was as follows:

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Cash paid for amounts included in the measurement of lease liabilities:			
Operating cash flows from operating leases	**$ 1,522**	$ 1,157	$ 936
Operating cash flows from finance leases	**175**	68	28
Financing cash flows from finance leases	**144**	46	6
Right-of-use assets obtained in exchange for lease obligations:			
Operating leases	**1,571**	1,270	1,062
Finance leases	**1,933**	1,773	413

Supplemental balance sheet information related to leases was as follows:

(In millions, except lease term and discount rate)

June 30,	**2018**	**2017**
Operating Leases		
Operating lease right-of-use assets	**$ 6,686**	$ 6,555
Other current liabilities	**$ 1,399**	$ 1,423
Operating lease liabilities	**5,568**	5,372
Total operating lease liabilities	**$ 6,967**	$ 6,795
Finance Leases		
Property and equipment, gross	**$ 4,543**	$ 2,658
Accumulated depreciation	**(404)**	(161)
Property and equipment, net	**$ 4,139**	$ 2,497
Other current liabilities	**$ 176**	$ 113
Other long-term liabilities	**4,125**	2,425
Total finance lease liabilities	**$ 4,301**	$ 2,538
Weighted Average Remaining Lease Term		
Operating leases	**7 years**	7 years
Finance leases	**13 years**	13 years
Weighted Average Discount Rate		
Operating leases	**2.7%**	2.5%
Finance leases	**5.2%**	4.7%

Maturities of lease liabilities were as follows:

(In millions)

Year Ending June 30,	**Operating Leases**	**Finance Leases**
2019	$ 1,492	$ 386
2020	1,347	393
2021	1,086	401
2022	902	408
2023	721	410
Thereafter	2,157	4,036
Total lease payments	7,705	6,034
Less imputed interest	(738)	(1,733)
Total	$ 6,967	$ 4,301

As of June 30, 2018, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $594 million and $2.4 billion, respectively. These operating and finance leases will commence between fiscal year 2019 and fiscal year 2020 with lease terms of 1 year to 20 years.

NOTE 17 — CONTINGENCIES

Patent and Intellectual Property Claims

There were 34 patent infringement cases pending against Microsoft as of June 30, 2018, none of which are material individually or in aggregate.

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. Following a mediation, the parties agreed to a global settlement of all three Canadian actions, and have submitted the proposed settlement agreement to the courts in all three jurisdictions for approval. The courts will likely reach a decision on approval in September 2018.

Other Antitrust Litigation and Claims

China State Administration for Industry and Commerce Investigation

In 2014, Microsoft was informed that China's State Agency for Market Regulation ("SAMR") (formerly State Administration for Industry and Commerce) had begun a formal investigation relating to China's Anti-Monopoly Law, and the SAMR conducted onsite inspections of Microsoft offices in Beijing, Shanghai, Guangzhou, and Chengdu. SAMR 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

Microsoft Mobile Oy, a subsidiary of Microsoft, along with other handset manufacturers and network operators, is a defendant in 35 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 in our agreement to acquire Nokia's Devices and Services business 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 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, the defendants in the consolidated cases moved to exclude the plaintiffs' expert evidence of general causation on the basis of flawed scientific methodologies. In 2014, the trial court granted in part and denied in part the defendants' motion to exclude the plaintiffs' general causation experts. The defendants filed an interlocutory appeal challenging the standard for evaluating expert scientific evidence, which the District of Columbia Court of Appeals heard *en banc*. In October 2016, the Court of Appeals issued its decision adopting the standard advocated by the defendants and remanding the cases to the trial court for further proceedings under that standard. The plaintiffs have filed supplemental expert evidence, portions of which the defendants have moved to strike.

Canadian Cell Phone Class Action

Microsoft Mobile Oy, 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, alleging adverse health effects from cellular phone use. Microsoft was served with the complaint in June 2014 and has been substituted for the Nokia defendants. The litigation has been dormant for more than three years.

Employment-Related Litigation

Moussouris v. Microsoft

Current and former female Microsoft employees in certain engineering and information technology roles brought this class action in federal court in Seattle in 2015, alleging systemic gender discrimination in pay and promotions. The plaintiffs moved to certify the class in October 2017. Microsoft filed an opposition in January 2018, attaching an expert report showing no statistically significant disparity in pay and promotions between similarly situated men and women. In June 2018, the court denied the plaintiffs' motion for class certification. The plaintiffs have appealed to the U.S. Court of Appeals for the Ninth Circuit. In July, the court denied Microsoft's motion for summary judgment with respect to the named plaintiffs.

Other Contingencies

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 in 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, 2018, we accrued aggregate legal liabilities of $323 million. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $1.1 billion in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact in our consolidated financial statements for the period in which the effects become reasonably estimable.

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. In evaluating estimated losses on these obligations, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. These obligations did not have a material impact in our consolidated financial statements during the periods presented.

NOTE 18 — STOCKHOLDERS' EQUITY

Shares Outstanding

Shares of common stock outstanding were as follows:

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Balance, beginning of year	**7,708**	7,808	8,027
Issued	**68**	70	75
Repurchased	**(99)**	(170)	(294)
Balance, end of year	**7,677**	7,708	7,808

Share Repurchases

On September 16, 2013, our Board of Directors approved a share repurchase program authorizing up to $40.0 billion in share repurchases. This share repurchase program became effective on October 1, 2013, and was completed on December 22, 2016.

On September 20, 2016, our Board of Directors approved a share repurchase program authorizing up to an additional $40.0 billion in share repurchases. This share repurchase program commenced on December 22, 2016 following completion of the prior program approved on September 16, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of June 30, 2018, $28.2 billion remained of this $40.0 billion share repurchase program.

We repurchased the following shares of common stock under the share repurchase programs:

(In millions)	Shares	Amount	Shares	Amount	Shares	Amount
Year Ended June 30,		2018		2017		2016
First Quarter	**22**	**$ 1,600**	63	$ 3,550	89	$ 4,000
Second Quarter	**22**	**1,800**	59	3,533	66	3,600
Third Quarter	**34**	**3,100**	25	1,600	69	3,600
Fourth Quarter	**21**	**2,100**	23	1,600	70	3,600
Total	**99**	**$ 8,600**	170	$ 10,283	294	$ 14,800

Shares repurchased beginning in the third quarter of fiscal year 2017 were under the share repurchase program approved September 20, 2016. All other shares repurchased were under the share repurchase program approved September 16, 2013. The above table excludes shares repurchased to settle employee tax withholding related to the vesting of stock awards. All repurchases were made using cash resources.

Dividends

Our Board of Directors declared the following dividends:

Declaration Date	Dividend Per Share	Record Date	Amount	Payment Date
Fiscal Year 2018			(in millions)	
September 19, 2017	**$ 0.42**	**November 16, 2017**	**$ 3,238**	**December 14, 2017**
November 29, 2017	**0.42**	**February 15, 2018**	**3,232**	**March 8, 2018**
March 12, 2018	**0.42**	**May 17, 2018**	**3,226**	**June 14, 2018**
June 13, 2018	**0.42**	**August 16, 2018**	**3,224**	**September 13, 2018**
Fiscal Year 2017				
September 20, 2016	$ 0.39	November 17, 2016	$ 3,024	December 8, 2016
November 30, 2016	0.39	February 16, 2017	3,012	March 9, 2017
March 14, 2017	0.39	May 18, 2017	3,009	June 8, 2017
June 13, 2017	0.39	August 17, 2017	3,003	September 14, 2017

The dividend declared on June 13, 2018 was included in other current liabilities as of June 30, 2018.

NOTE 19 — ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

(In millions)

Year Ended June 30,	2018	2017	2016
Derivatives			
Balance, beginning of period	**$ 134**	$ 352	$ 590
Unrealized gains, net of tax of **$11**, $4, and $24	**218**	328	351
Reclassification adjustments for gains included in revenue	**(185)**	(555)	(625)
Tax expense included in provision for income taxes	**6**	9	36
Amounts reclassified from accumulated other comprehensive income	**(179)**	(546)	(589)
Net change related to derivatives, net of tax of **$5,** $(5), and $(12)	**39**	(218)	(238)
Balance, end of period	**$ 173**	$ 134	$ 352
Investments			
Balance, beginning of period	**$ 1,825**	$ 2,941	$ 3,169
Unrealized gains (losses), net of tax of **$(427)**, $267, and $120	**(1,146)**	517	219
Reclassification adjustments for gains included in other income (expense), net	**(2,309)**	(2,513)	(688)
Tax expense included in provision for income taxes	**738**	880	241
Amounts reclassified from accumulated other comprehensive income	**(1,571)**	(1,633)	(447)
Net change related to investments, net of tax of **$(1,165)**, $(613), and $(121)	**(2,717)**	(1,116)	(228)
Balance, end of period	**$ (892)**	$ 1,825	$ 2,941
Translation Adjustments and Other			
Balance, beginning of period	**$ (1,332)**	$ (1,499)	$ (1,237)
Translation adjustments and other, net of tax effects of **$0**, $9, and $(33)	**(178)**	167	(262)
Balance, end of period	**$ (1,510)**	$ (1,332)	$ (1,499)
Cumulative effect of accounting change	**42**	0	0
Accumulated other comprehensive income (loss), end of period	**$ (2,187)**	$ 627	$ 1,794

NOTE 20 — EMPLOYEE STOCK AND SAVINGS PLANS

We grant stock-based compensation to employees and directors. As of June 30, 2018, an aggregate of 381 million shares were authorized for future grant under our stock plans. In fiscal year 2018, our Board of Directors approved the 2017 Stock Plan, which authorized an additional 308 million shares 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 vesting of awards granted under 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,	2018	2017	2016
Stock-based compensation expense	**$ 3,940**	$ 3,266	$ 2,668
Income tax benefits related to stock-based compensation	**823**	1,066	882

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. RSUs generally vest ratably over a four-year service period. PSUs generally vest over a three-year performance period. The number of shares the PSU holder receives is based on the extent to which the corresponding performance goals have been achieved.

Activity for All Stock Plans

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

Year Ended June 30,	2018	2017	2016
Dividends per share (quarterly amounts)	**$ 0.39 - $ 0.42**	$ 0.36 - $ 0.39	$ 0.31 - $ 0.36
Interest rates	**1.7% - 2.9%**	1.2% - 2.2%	1.1% - 1.8%

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

	Shares	Weighted Average Grant-Date Fair Value
	(In millions)	
Stock Awards		
Nonvested balance, beginning of year	**201**	**$ 46.32**
Granted (a)	**70**	**75.88**
Vested	**(80)**	**45.74**
Forfeited	**(17)**	**53.41**
Nonvested balance, end of year	**174**	**57.85**

(a) *Includes 3 million, 2 million, and 1 million of PSUs granted at target and performance adjustments above target levels for fiscal years 2018, 2017, and 2016, respectively.*

As of June 30, 2018, there was approximately $7.0 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 awards granted was $75.88, $55.64, and $41.51 for fiscal years 2018, 2017, and 2016, respectively. The fair value of stock awards vested was $6.6 billion, $4.8 billion, and $3.9 billion, for fiscal years 2018, 2017, and 2016, 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,	2018	2017	2016
Shares purchased	**13**	13	15
Average price per share	**$ 76.40**	$ 56.36	$ 44.83

As of June 30, 2018, 116 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. 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. Matching contributions for all plans were $807 million, $734 million, and $549 million in fiscal years 2018, 2017, and 2016, 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, who is also our Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with GAAP. During the periods presented, we reported our financial performance based on the following segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing.

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 Office 365 subscriptions and Office licensed on-premises, comprising Office, Exchange, SharePoint, Skype for Business, and Microsoft Teams, and related Client Access Licenses (“CALs”).
- Office Consumer, including Office 365 subscriptions and Office licensed on-premises, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.
- LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.
- Dynamics business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.

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, and 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 all devices. This segment primarily comprises:

- Windows, including Windows OEM licensing and other non-volume licensing of the Windows operating system; Windows Commercial, comprising volume licensing of the Windows operating system, Windows cloud services, and other Windows commercial offerings; patent licensing; Windows Internet of Things (“IoT”); and MSN advertising.
- Devices, including Microsoft Surface, PC accessories, and other intelligent devices.

- Gaming, including Xbox hardware and Xbox software and services, comprising Xbox Live transactions, subscriptions, and advertising (“Xbox Live”), video games, and third-party video game royalties.
- Search.

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 from 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 and restructuring expenses.

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

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
Revenue			
Productivity and Business Processes	**$ 35,865**	$ 29,870	$ 25,792
Intelligent Cloud	**32,219**	27,407	24,952
More Personal Computing	**42,276**	39,294	40,410
Total	**$ 110,360**	$ 96,571	$ 91,154
Operating Income (Loss)			
Productivity and Business Processes	**$ 12,924**	$ 11,389	$ 11,756
Intelligent Cloud	**11,524**	9,127	9,249
More Personal Computing	**10,610**	8,815	6,183
Corporate and Other	**0**	(306)	(1,110)
Total	**$ 35,058**	$ 29,025	$ 26,078

Corporate and Other operating loss comprised impairment and restructuring expenses.

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

(In millions)

Year Ended June 30,	**2018**	**2017**	**2016**
United States [(a)]	**$ 55,926**	$ 51,078	$ 46,416
Other countries	**54,434**	45,493	44,738
Total	**$ 110,360**	$ 96,571	$ 91,154

(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, was as follows:

(In millions)

Year Ended June 30,	2018	2017	2016
Office products and cloud services	**$ 28,316**	$ 25,573	$ 23,868
Server products and cloud services	**26,129**	21,649	19,062
Windows	**19,518**	18,593	17,548
Gaming	**10,353**	9,051	9,202
Search advertising	**7,012**	6,219	5,428
Enterprise Services	**5,846**	5,542	5,659
Devices	**5,134**	5,062	7,888
LinkedIn	**5,259**	2,271	0
Other	**2,793**	2,611	2,499
Total	**$ 110,360**	$ 96,571	$ 91,154

Our commercial cloud revenue, which primarily comprises Office 365 commercial, Azure, Dynamics 365, and other cloud properties, was $23.2 billion, $14.9 billion, and $9.5 billion in fiscal years 2018, 2017, and 2016, respectively. These amounts are primarily included in Office products and services and server products and cloud services 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,	2018	2017	2016
United States	**$ 44,501**	$ 42,730	$ 25,145
Ireland	**12,843**	12,889	2,099
Luxembourg	**6,856**	6,854	6,868
Other countries	**15,682**	13,044	11,047
Total	**$ 79,882**	$ 75,517	$ 45,159

NOTE 22 — QUARTERLY INFORMATION (UNAUDITED)

(In millions, except per share amounts)

Quarter Ended	**September 30**	**December 31**	**March 31**	**June 30**	**Total**
Fiscal Year 2018					
Revenue	**$ 24,538**	**$ 28,918**	**$ 26,819**	**$ 30,085**	**$ 110,360**
Gross margin	**16,260**	**17,854**	**17,550**	**20,343**	**72,007**
Operating income	**7,708**	**8,679**	**8,292**	**10,379**	**35,058**
Net income (loss) [(a)]	**6,576**	**(6,302)**	**7,424**	**8,873**	**16,571**
Basic earnings (loss) per share	**0.85**	**(0.82)**	**0.96**	**1.15**	**2.15**
Diluted earnings (loss) per share [(b)]	**0.84**	**(0.82)**	**0.95**	**1.14**	**2.13**
Fiscal Year 2017 [(c)]					
Revenue	$ 21,928	$ 25,826	$ 23,212	$ 25,605	$ 96,571
Gross margin	14,084	15,925	15,152	17,149	62,310
Operating income	6,715	7,905	6,723	7,682 [(d)]	29,025 [(d)]
Net income	5,667	6,267	5,486	8,069 [(d)]	25,489 [(d)]
Basic earnings per share	0.73	0.81	0.71	1.05	3.29
Diluted earnings per share	0.72	0.80	0.70	1.03 [(d)]	3.25 [(d)]

(a) *Reflects the net charge (benefit) related to the TCJA of $13.8 billion for the second quarter, $(104) million for the fourth quarter, and $13.7 billion for fiscal year 2018.*

(b) *Reflects the net charge (benefit) related to the TCJA, which decreased (increased) diluted EPS $1.78 for the second quarter, $(0.01) for the fourth quarter, and $1.75 for fiscal year 2018.*

(c) *On December 8, 2016, we acquired LinkedIn Corporation. LinkedIn has been included in our consolidated results of operations starting on the acquisition date.*

(d) *Includes $306 million of employee severance expenses primarily related to our sales and marketing restructuring plan, which decreased operating income, net income, and diluted EPS by $306 million, $243 million, and $0.04, respectively.*

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of Microsoft Corporation

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2018 and 2017, the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended June 30, 2018, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2018, 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) ("PCAOB"), the Company's internal control over financial reporting as of June 30, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 3, 2018, expressed an unqualified opinion on the Company's internal control over financial reporting.

Change in Accounting Principles

As discussed in Note 1 to the financial statements, the Company has changed its method of accounting for revenue from contracts with customers and for accounting for leases in fiscal year 2018 due to the adoption of the new revenue standard and new lease standard, respectively. The Company adopted the new revenue standard using the full retrospective approach and adopted the new lease standard using a modified retrospective approach.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
August 3, 2018

We have served as the Company's auditor since 1983.

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective.

REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the company. Internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of our financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes maintaining records that in reasonable detail accurately and fairly reflect our transactions; providing reasonable assurance that transactions are recorded as necessary for preparation of our financial statements; providing reasonable assurance that receipts and expenditures of company assets are made in accordance with management authorization; and providing reasonable assurance that unauthorized acquisition, use, or disposition of company assets that could have a material effect on our financial statements would be prevented or detected on a timely basis. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected.

Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of June 30, 2018. Deloitte & Touche LLP has audited our internal control over financial reporting as of June 30, 2018; their report follows.

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We implemented internal controls to ensure we adequately evaluated our contracts and properly assessed the impact of the new accounting standards related to revenue recognition and leases on our financial statements to facilitate their adoption on July 1, 2017. There were no significant changes to our internal control over financial reporting due to the adoption of the new standards.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of Microsoft Corporation

Opinion on Internal Control over Financial Reporting

We have audited the internal control over financial reporting of Microsoft Corporation and subsidiaries (the "Company") as of June 30, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2018, based on the criteria established in *Internal Control – Integrated Framework (2013)* issued by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated financial statements and the related notes (collectively referred to as the "financial statements") as of and for the year ended June 30, 2018, of the Company and our report dated August 3, 2018, expressed an unqualified opinion on those financial statements and included an explanatory paragraph related to the Company's change in method of accounting for revenue from contracts with customers and for accounting for leases in fiscal year 2018 due to the adoption of the new revenue standard and new lease standard, respectively.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington
August 3, 2018

DIRECTORS AND EXECUTIVE OFFICERS OF MICROSOFT CORPORATION

DIRECTORS

John W. Thompson [3,4]
Independent Chairman,
Microsoft Corporation

William H. Gates III
Co-Chair and Trustee,
Bill & Melinda Gates Foundation

Reid G. Hoffman
Partner, Greylock Partners

Hugh F. Johnston [1]
Vice Chairman and Chief Financial Officer, PepsiCo

Teri L. List-Stoll [1, 3]
Executive Vice President and Chief Financial Officer, Gap, Inc.

Satya Nadella
Chief Executive Officer,
Microsoft Corporation

Charles H. Noski [1,3]
Former Vice Chairman,
Bank of America Corporation

Helmut G. W. Panke [1,4]
Former Chairman of the Board of Management, BMW AG

Sandra E. Peterson [2,4]
Former Group Worldwide Chairman,
Johnson & Johnson

Penny S. Pritzker [4]
Founder and Chairman, PSP Partners

Charles W. Scharf [2,3]
Chief Executive Officer,
The Bank of New York Mellon Corporation

Arne Sorenson [1]
President and Chief Executive Officer,
Marriott International, Inc.

John W. Stanton [2,4]
Chairman, Trilogy Partnerships

Padmasree Warrior [2]
Chief Development Officer, NIO Inc.;
Chief Executive Officer, NIO USA, Inc.

Board Committees
1. Audit Committee
2. Compensation Committee
3. Governance and Nominating Committee
4. Regulatory and Public Policy Committee

EXECUTIVE OFFICERS

Satya Nadella
Chief Executive Officer

Christopher C. Capossela
Executive Vice President, Marketing and Consumer Business, and Chief Marketing Officer

Jean-Philippe Courtois
Executive Vice President and President, Microsoft Global Sales, Marketing and Operations

Kathleen T. Hogan
Executive Vice President, Human Resources

Amy E. Hood
Executive Vice President, Chief Financial Officer

Margaret L. Johnson
Executive Vice President, Business Development

Bradford L. Smith
President and Chief Legal Officer

INVESTOR RELATIONS

Investor Relations

You can contact Microsoft Investor Relations at any time to order financial documents such as annual reports and Form 10-Ks free of charge.

Call us toll-free at (800) 285-7772 or outside the United States, call (425) 706-4400. We can be contacted between the hours of 9:00 a.m. to 5:00 p.m. Pacific Time to answer investment oriented questions about Microsoft.

For access to additional financial information, visit the Investor Relations website online at:
www.microsoft.com/investor

Our e-mail is msft@microsoft.com

Our mailing address is:
Investor Relations
Microsoft Corporation
One Microsoft Way
Redmond, Washington 98052-6399

Annual Meeting

8:00 a.m. Pacific Time November 28, 2018
Meydenbauer Center
11100 NE 6th Street
Bellevue, Washington 98004

Proof of Ownership Required

You are entitled to attend the Annual Meeting only if you are a shareholder as of the close of business on September 26, 2018, the record date, or hold a valid proxy for the meeting. In order to be admitted to the Annual Meeting, you must present proof of ownership of Microsoft stock on the record date.

- The Notice of Internet Availability of Proxy Materials
- A proxy card
- Legal proxy provided by your bank, broker, or nominee
- Voting instruction card
- If you received your proxy materials by email, a printout of the email
- Brokerage statement or letter from a bank or broker indicating ownership on September 26, 2018

Any holder of a proxy from a shareholder must present the proxy card, properly executed, and a copy of the proof of ownership. Shareholders and proxy holders must also present a form of photo identification such as a driver's license or passport. We reserve the right to deny entry to any person who does not present identification or refuses to comply with our security procedures.

Registered Shareholder Services

American Stock Transfer & Trust Company (AST), our transfer agent, can help you with a variety of shareholder related services including:

- Change of address
- Lost stock certificates
- Transfer of stock to another person
- Additional administrative services

AST also administers a direct stock purchase plan and a dividend reinvestment program for the company.

To find out more about these services and programs you may contact AST directly at 800-285-7772, option 1 between the hours of 5:00 a.m. and 5:00 p.m. Pacific Time, Monday through Fridays, or visit AST online at:
https://www.astfinancial.com/

You can e-mail the transfer agent at:
msft@astfinancial.com

You can also send mail to the transfer agent at:
Microsoft Corporation
c/o American Stock Transfer & Trust Company
P.O. Box 2362
New York, NY 10272-2362

Shareholders can sign up for electronic alerts to access the annual report and proxy statement online. The service gets you the information you need faster and also gives you the power and convenience of online proxy voting. To sign up for this free service, visit the Annual Report site on the Investor Relations website at:
http://www.microsoft.com/investor/AnnualReports/default.aspx

Corporate Social Responsibility

We appreciate the inquiries we receive from many investors about our commitment to corporate social responsibility. Our CSR commitments contribute long-term value to our business, our shareholders, and communities around the world. Microsoft cannot fulfill our mission to empower every person and every organization on the planet to achieve more just by providing products and services that let our users do great things. Achieving that mission requires us to be thoughtful about the impact of our own business practices and policies and our investments in communities. And it's not a mission we can achieve alone. It requires partnerships to apply our technologies to address some of the world's toughest challenges. In short, we see corporate responsibility as both a responsibility and an opportunity to work together to advance societal needs and technology at the same time.

For more about Microsoft's CSR commitments and performance, please visit:
http://www.microsoft.com/csr.