MICROSOFT CORP
Form 10-Q
October 20, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended September 30, 2016

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From to

Commission File Number: 001-37845

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

Washington **(State or other jurisdiction of** **incorporation or organization)**	**91-1144442** **(I.R.S. Employer** **Identification No.)**
One Microsoft Way, Redmond, Washington **(Address of principal executive offices)**	**98052-6399** **(Zip Code)**

(425) 882-8080

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x

Accelerated filer ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company)

Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at October 14, 2016**
Common Stock, $0.00000625 par value per share	7,775,350,501 shares

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FORM 10-Q

For the Quarter Ended September 30, 2016

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)

Three Months Ended September 30,	**2016**	**2015**
Revenue:		
Product	**$ 13,493**	$ 15,219
Service and other	**6,960**	5,160
Total revenue	**20,453**	20,379
Cost of revenue:		
Product	**3,581**	4,035
Service and other	**4,263**	3,172
Total cost of revenue	**7,844**	7,207
Gross margin	**12,609**	13,172
Research and development	**3,106**	2,962
Sales and marketing	**3,233**	3,333
General and administrative	**1,045**	1,084
Operating income	**5,225**	5,793
Other income (expense), net	**100**	(280)
Income before income taxes	**5,325**	5,513
Provision for income taxes	**635**	611
Net income	**$ 4,690**	$ 4,902
Earnings per share:		
Basic	**$ 0.60**	$ 0.61
Diluted	**$ 0.60**	$ 0.61
Weighted average shares outstanding:		
Basic	**7,789**	7,996
Diluted	**7,876**	8,084
Cash dividends declared per common share	**$ 0.39**	$ 0.36

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	**2016**	**2015**
Net income	**$ 4,690**	$ 4,902
Other comprehensive income (loss):		
Net unrealized gains (losses) on derivatives (net of tax effects of **$(2)** and $23)	**(37)**	57
Net unrealized gains (losses) on investments (net of tax effects of **$44** and $(308))	**83**	(571)
Translation adjustments and other (net of tax effects of **$7** and $(12))	**98**	(270)
Other comprehensive income (loss)	**144**	(784)
Comprehensive income	**$ 4,834**	$ 4,118

See accompanying notes.

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BALANCE SHEETS

(In millions) (Unaudited)

	September 30, 2016	June 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	**$ 13,928**	$ 6,510
Short-term investments (including securities loaned of **$147** and $204)	**123,004**	106,730
Total cash, cash equivalents, and short-term investments	**136,932**	113,240
Accounts receivable, net of allowance for doubtful accounts of **$284** and $426	**11,129**	18,277
Inventories	**3,122**	2,251
Other	**6,726**	5,892
Total current assets	**157,909**	139,660
Property and equipment, net of accumulated depreciation of **$20,885** and $19,800	**19,224**	18,356
Equity and other investments	**10,486**	10,431
Goodwill	**17,907**	17,872
Intangible assets, net	**3,522**	3,733
Other long-term assets	**3,476**	3,416
Total assets	**$ 212,524**	$ 193,468
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 6,296**	$ 6,898
Short-term debt	**14,536**	12,904
Accrued compensation	**3,621**	5,264
Income taxes	**720**	580
Short-term unearned revenue	**26,304**	27,468
Securities lending payable	**210**	294
Other	**7,123**	5,949
Total current liabilities	**58,810**	59,357
Long-term debt	**60,154**	40,557
Long-term unearned revenue	**7,284**	6,441
Deferred income taxes	**1,564**	1,476
Other long-term liabilities	**14,340**	13,640
Total liabilities	**142,152**	121,471
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **7,784** and 7,808	**67,747**	68,178

Retained earnings	**944**	2,282
Accumulated other comprehensive income	**1,681**	1,537
Total stockholders equity	**70,372**	71,997
Total liabilities and stockholders equity	**$ 212,524**	$ 193,468

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	**2016**	**2015**
Operations		
Net income	**$ 4,690**	$ 4,902
Adjustments to reconcile net income to net cash from operations:		
Depreciation, amortization, and other	**1,816**	1,461
Stock-based compensation expense	**703**	674
Net recognized losses (gains) on investments and derivatives	**(311)**	101
Deferred income taxes	**15**	73
Deferral of unearned revenue	**12,583**	10,423
Recognition of unearned revenue	**(12,904)**	(11,355)
Changes in operating assets and liabilities:		
Accounts receivable	**7,174**	6,376
Inventories	**(867)**	(937)
Other current assets	**(966)**	(562)
Other long-term assets	**(29)**	(5)
Accounts payable	**(443)**	(135)
Other current liabilities	**(361)**	(2,024)
Other long-term liabilities	**449**	(116)
Net cash from operations	**11,549**	8,876
Financing		
Proceeds from issuance (repayments) of short-term debt, maturities of 90 days or less, net	**(3,390)**	4,890
Proceeds from issuance of debt	**24,977**	121
Repayments of debt	**(225)**	(1,750)
Common stock issued	**241**	219
Common stock repurchased	**(4,362)**	(4,757)
Common stock cash dividends paid	**(2,800)**	(2,475)
Other	**(112)**	(178)
Net cash from (used in) financing	**14,329**	(3,930)
Investing		
Additions to property and equipment	**(2,163)**	(1,356)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(24)**	(390)
Purchases of investments	**(57,181)**	(37,570)
Maturities of investments	**8,659**	5,686
Sales of investments	**32,323**	28,502
Securities lending payable	**(84)**	62
Net cash used in investing	**(18,470)**	(5,066)

Effect of foreign exchange rates on cash and cash equivalents	**10**	(44)
Net change in cash and cash equivalents	**7,418**	(164)
Cash and cash equivalents, beginning of period	**6,510**	5,595
Cash and cash equivalents, end of period	**$ 13,928**	$ 5,431

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	2016	2015
Common stock and paid-in capital		
Balance, beginning of period	**$ 68,178**	$ 68,465
Common stock issued	**241**	219
Common stock repurchased	**(1,374)**	(1,548)
Stock-based compensation expense	**703**	674
Other, net	**(1)**	1
Balance, end of period	**67,747**	67,811
Retained earnings		
Balance, beginning of period	**2,282**	9,096
Net income	**4,690**	4,902
Common stock cash dividends	**(3,025)**	(2,862)
Common stock repurchased	**(3,003)**	(3,240)
Balance, end of period	**944**	7,896
Accumulated other comprehensive income		
Balance, beginning of period	**1,537**	2,522
Other comprehensive income (loss)	**144**	(784)
Balance, end of period	**1,681**	1,738
Total stockholders equity	**$ 70,372**	$ 77,445

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1   ACCOUNTING POLICIES

Accounting Principles

We prepare our unaudited interim consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair presentation of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Microsoft Corporation 2016 Form 10-K filed with the U.S. Securities and Exchange Commission on July 28, 2016.

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

Principles of Consolidation

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

Estimates and Assumptions

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

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; hardware such as PCs, tablets, gaming and entertainment consoles, phones, other intelligent devices, and related accessories; and training and certification of computer system integrators and developers.

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

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Recent Accounting Guidance Not Yet Adopted

Financial Instruments Credit Losses

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

Leases

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

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

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

Financial Instruments Recognition, Measurement, Presentation, and Disclosure

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

Revenue from Contracts with Customers

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

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

The new standard will be effective for us beginning July 1, 2018, and adoption as of the original effective date of July 1, 2017 is permitted. We currently anticipate early adoption of the new standard effective July 1, 2017. Our

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ability to early adopt using the full retrospective method is dependent on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior period financial statements.

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

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

NOTE 2 EARNINGS PER SHARE

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

The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)

Three Months Ended September 30,	**2016**	**2015**
Net income available for common shareholders (A)	**$ 4,690**	$ 4,902
Weighted average outstanding shares of common stock (B)	**7,789**	7,996
Dilutive effect of stock-based awards	**87**	88
Common stock and common stock equivalents (C)	**7,876**	8,084
Earnings Per Share		
Basic (A/B)	**$ 0.60**	$ 0.61
Diluted (A/C)	**$ 0.60**	$ 0.61

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)