UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended December 31, 2011

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: 0-14278

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 ☒ 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 ☒ 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 ☒	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 ☒

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 January 17, 2012**
Common Stock, $0.00000625 par value per share	8,390,771,388 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 2011

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Revenue	**$ 20,885**	$ 19,953	**$ 38,257**	$ 36,148
Operating expenses:				
Cost of revenue	**5,638**	4,833	**9,415**	7,972
Research and development	**2,371**	2,185	**4,700**	4,381
Sales and marketing	**3,762**	3,825	**6,662**	6,631
General and administrative	**1,120**	945	**2,283**	1,883
Total operating expenses	**12,891**	11,788	**23,060**	20,867
Operating income	**7,994**	8,165	**15,197**	15,281
Other income	**245**	332	**348**	446
Income before income taxes	**8,239**	8,497	**15,545**	15,727
Provision for income taxes	**1,615**	1,863	**3,183**	3,683
Net income	**$ 6,624**	$ 6,634	**$ 12,362**	$ 12,044
Earnings per share:				
Basic	**$ 0.79**	$ 0.78	**$ 1.47**	$ 1.41
Diluted	**$ 0.78**	$ 0.77	**$ 1.46**	$ 1.39
Weighted average shares outstanding:				
Basic	**8,402**	8,497	**8,397**	8,555
Diluted	**8,465**	8,570	**8,489**	8,646
Cash dividends declared per common share	**$ 0.20**	$ 0.16	**$ 0.40**	$ 0.32

See accompanying notes.

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PART I
Item 1

BALANCE SHEETS

(In millions) (Unaudited)

	December 31, 2011	June 30, 2011(1)
Assets		
Current assets:		
Cash and cash equivalents	**$ 10,610**	$ 9,610
Short-term investments (including securities loaned of **$831** and $1,181)	**41,126**	43,162
Total cash, cash equivalents, and short-term investments	**51,736**	52,772
Accounts receivable, net of allowance for doubtful accounts of **$321** and $333	**13,643**	14,987
Inventories	**1,351**	1,372
Deferred income taxes	**2,169**	2,467
Other	**3,614**	3,320
Total current assets	**72,513**	74,918
Property and equipment, net of accumulated depreciation of **$10,546** and $9,829	**8,010**	8,162
Equity and other investments	**7,550**	10,865
Goodwill	**19,670**	12,581
Intangible assets, net	**2,581**	744
Other long-term assets	**1,919**	1,434
Total assets	**$ 112,243**	$ 108,704
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	**$ 3,884**	$ 4,197
Accrued compensation	**2,677**	3,575
Income taxes	**921**	580
Short-term unearned revenue	**13,985**	15,722
Securities lending payable	**849**	1,208
Other	**3,057**	3,492
Total current liabilities	**25,373**	28,774
Long-term debt	**11,932**	11,921
Long-term unearned revenue	**1,349**	1,398
Deferred income taxes	**1,082**	1,456
Other long-term liabilities	**8,386**	8,072
Total liabilities	**48,122**	51,621
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital—shares authorized 24,000; outstanding **8,382** and 8,376	**63,902**	63,415
Retained earnings (deficit), including accumulated other comprehensive income of **$826** and $1,863	**219**	(6,332)
Total stockholders' equity	**64,121**	57,083
Total liabilities and stockholders' equity	**$ 112,243**	$ 108,704

(1) *Derived from audited financial statements.*

See accompanying notes.

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PART I
Item 1

CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Operations				
Net income	**$ 6,624**	$ 6,634	**$ 12,362**	$ 12,044
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other	**678**	663	**1,404**	1,357
Stock-based compensation expense	**575**	553	**1,133**	1,081
Net recognized gains on investments and derivatives	**(112)**	(226)	**(142)**	(255)
Excess tax benefits from stock-based compensation	**(4)**	(4)	**(74)**	(9)
Deferred income taxes	**14**	(117)	**416**	(265)
Deferral of unearned revenue	**7,544**	6,834	**13,683**	12,715
Recognition of unearned revenue	**(8,057)**	(7,301)	**(15,710)**	(14,163)
Changes in operating assets and liabilities:				
Accounts receivable	**(3,652)**	(3,270)	**1,081**	404
Inventories	**891**	380	**(29)**	(88)
Other current assets	**605**	(77)	**865**	131
Other long-term assets	**30**	118	**(45)**	180
Accounts payable	**176**	216	**(266)**	(184)
Other current liabilities	**394**	(500)	**(599)**	(1,411)
Other long-term liabilities	**156**	283	**276**	843
Net cash from operations	**5,862**	4,186	**14,355**	12,380
Financing				
Short-term debt repayments, maturities of 90 days or less, net	**0**	(1,000)	**0**	(186)
Proceeds from issuance of debt, maturities longer than 90 days	**0**	0	**0**	4,721
Repayments of debt, maturities longer than 90 days	**0**	0	**0**	(814)
Common stock issued	**208**	660	**544**	837
Common stock repurchased	**(1,042)**	(5,052)	**(2,976)**	(9,451)
Common stock cash dividends paid	**(1,683)**	(1,363)	**(3,024)**	(2,481)
Excess tax benefits from stock-based compensation	**4**	4	**74**	9
Other	**0**	0	**0**	(25)
Net cash used in financing	**(2,513)**	(6,751)	**(5,382)**	(7,390)
Investing				
Additions to property and equipment	**(498)**	(491)	**(934)**	(1,055)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(8,627)**	(69)	**(9,502)**	(69)
Purchases of investments	**(10,047)**	(5,896)	**(21,346)**	(13,313)
Maturities of investments	**6,061**	1,836	**8,886**	2,706
Sales of investments	**7,835**	2,603	**15,371**	4,030
Securities lending payable	**(292)**	447	**(358)**	1,174
Net cash used in investing	**(5,568)**	(1,570)	**(7,883)**	(6,527)
Effect of exchange rates on cash and cash equivalents	**(52)**	(3)	**(90)**	55
Net change in cash and cash equivalents	**(2,271)**	(4,138)	**1,000**	(1,482)
Cash and cash equivalents, beginning of period	**12,881**	8,161	**9,610**	5,505
Cash and cash equivalents, end of period	**$ 10,610**	$ 4,023	**$ 10,610**	$ 4,023

See accompanying notes.

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PART I
Item 1

STOCKHOLDERS' EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Common stock and paid-in capital				
Balance, beginning of period	**$ 63,492**	$ 61,935	**$ 63,415**	$ 62,856
Common stock issued	**208**	660	**544**	837
Common stock repurchased	**(340)**	(1,405)	**(1,164)**	(2,980)
Stock-based compensation expense	**575**	553	**1,133**	1,081
Stock-based compensation income tax deficiencies	**(35)**	(97)	**(29)**	(148)
Other, net	**2**	0	**3**	0
Balance, end of period	**63,902**	61,646	**63,902**	61,646
Retained earnings (deficit)				
Balance, beginning of period	**(4,101)**	(14,993)	**(6,332)**	(16,681)
Net income	**6,624**	6,634	**12,362**	12,044
Other comprehensive income:				
Net unrealized gains (losses) on derivatives	**76**	(80)	**236**	(586)
Net unrealized gains (losses) on investments	**124**	284	**(1,025)**	1,016
Translation adjustments and other	**(125)**	(26)	**(248)**	212
Comprehensive income	**6,699**	6,812	**11,325**	12,686
Common stock cash dividends	**(1,677)**	(1,337)	**(3,360)**	(2,699)
Common stock repurchased	**(702)**	(3,647)	**(1,414)**	(6,471)
Balance, end of period	**219**	(13,165)	**219**	(13,165)
Total stockholders' equity	**$ 64,121**	$ 48,481	**$ 64,121**	$ 48,481

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Accounting Principles

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP"). 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 2011 Form 10-K filed on July 28, 2011 with the U.S. Securities and Exchange Commission.

Principles of Consolidation

The financial statements include the accounts of Microsoft Corporation and its subsidiaries. Intercompany transactions and balances have been eliminated. Equity investments through which we 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 include: estimates of loss contingencies, product warranties, product life cycles, product returns, and stock-based compensation forfeiture rates; assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/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 in our financial statements or tax returns; estimating the fair value and/or potential goodwill impairment for our reporting units; and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

Recently Adopted Accounting Guidance

On July 1, 2011, we adopted guidance issued by the Financial Accounting Standards Board ("FASB") on disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll-forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). Adoption of this new guidance did not have a material impact on our financial statements.

Recent Accounting Guidance Not Yet Adopted

In December 2011, the FASB issued guidance enhancing disclosure requirements about the nature of an entity's right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. The new guidance will be effective for us beginning July 1, 2013. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

In September 2011, the FASB issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. The new guidance will be effective for us beginning July 1, 2012.

In June 2011, the FASB issued guidance on presentation of comprehensive income. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. Instead, an entity will be required to present either a continuous statement of net income and other comprehensive income or in two separate but consecutive statements. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. In December 2011, the FASB issued guidance which indefinitely defers the guidance related to the presentation of reclassification adjustments. The new guidance will be effective for us beginning July 1, 2012 and will have financial statement presentation changes only.

In May 2011, the FASB issued guidance to amend the accounting and disclosure requirements on fair value measurements. The new guidance limits the highest-and-best-use measure to nonfinancial assets, permits certain financial assets and liabilities with offsetting positions in market or counterparty credit risks to be measured at a net basis, and provides guidance on the applicability of premiums and discounts. Additionally, the new guidance expands the disclosures on Level 3 inputs by requiring quantitative disclosure of the unobservable inputs and assumptions, as well as description of the valuation processes and the sensitivity of the fair value to changes in unobservable inputs. The new guidance will be effective for us beginning January 1, 2012. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

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, stock awards, and shared performance stock awards. The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)	**Three Months Ended December 31,**		**Six Months Ended December 31,**	
	2011	**2010**	**2011**	**2010**
Net income available for common shareholders (A)	**$ 6,624**	$ 6,634	**$ 12,362**	$ 12,044
Weighted average outstanding shares of common stock (B)	**8,402**	8,497	**8,397**	8,555
Dilutive effect of stock-based awards	**63**	73	**92**	91
Common stock and common stock equivalents (C)	**8,465**	8,570	**8,489**	8,646
Earnings Per Share:				
Basic (A/B)	**$ 0.79**	$ 0.78	**$ 1.47**	$ 1.41
Diluted (A/C)	**$ 0.78**	$ 0.77	**$ 1.46**	$ 1.39

We excluded the following shares underlying stock-based awards from the calculations of diluted EPS because their inclusion would have been anti-dilutive:

(In millions)	**Three Months Ended December 31,**		**Six Months Ended December 31,**	
	2011	**2010**	**2011**	**2010**
Shares excluded from calculations of diluted EPS	**4**	56	**4**	57

The decrease in anti-dilutive shares from the comparable period was due mainly to the decrease in employee stock options outstanding.

In June 2010, we issued $1.25 billion of zero-coupon debt securities that are convertible into shares of our common stock if certain conditions are met. As of December 31, 2011, none of these securities had met price or other conditions that would make them eligible for issuance and therefore were excluded from the calculation of either the basic or diluted EPS. See Note 11 – Debt for additional information.

NOTE 3 OTHER INCOME

The components of other income were as follows:

(In millions)	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Dividends and interest income	$ 182	$ 205	$ 393	$ 415
Interest expense	(95)	(72)	(189)	(117)
Net recognized gains on investments	315	118	318	152
Net gains (losses) on derivatives	(203)	108	(176)	103
Net losses on foreign currency remeasurements	(4)	(27)	(44)	(69)
Other	50	0	46	(38)
Total	$ 245	$ 332	$ 348	$ 446

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

(In millions)	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Other-than-temporary impairments of investments	$ (107)	$ (18)	$ (152)	$ (27)
Realized gains from sales of available-for-sale securities	643	214	843	315
Realized losses from sales of available-for-sale securities	(221)	(78)	(373)	(136)
Total	$ 315	$ 118	$ 318	$ 152

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
December 31, 2011							
Cash	$ 2,349	$ 0	$ 0	$ 2,349	$ 2,349	$ 0	$ 0
Mutual funds	816	0	0	816	816	0	0
Commercial paper	465	0	0	465	350	115	0
Certificates of deposit	1,003	0	0	1,003	688	315	0
U.S. government and agency securities	31,548	153	(1)	31,700	510	31,190	0
Foreign government bonds	888	26	(32)	882	0	882	0
Mortgage-backed securities	1,910	111	(3)	2,018	0	2,018	0
Corporate notes and bonds	11,891	180	(29)	12,042	5,897	6,145	0
Municipal securities	403	54	0	457	0	457	0
Common and preferred stock	6,044	1,274	(478)	6,840	0	0	6,840
Other investments	714	0	0	714	0	4	710
Total	$ 58,031	$ 1,798	$ (543)	$ 59,286	$ 10,610	$ 41,126	$ 7,550

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(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2011							
Cash	$ 1,648	$ 0	$ 0	$ 1,648	$ 1,648	$ 0	$ 0
Mutual funds	1,752	0	0	1,752	1,752	0	0
Commercial paper	639	0	0	639	414	225	0
Certificates of deposit	598	0	0	598	372	226	0
U.S. government and agency securities	33,607	162	(7)	33,762	2,049	31,713	0
Foreign government bonds	658	11	(2)	667	0	667	0
Mortgage-backed securities	2,307	121	(4)	2,424	0	2,424	0
Corporate notes and bonds	10,575	260	(11)	10,824	3,375	7,449	0
Municipal securities	441	15	(2)	454	0	454	0
Common and preferred stock	7,925	2,483	(193)	10,215	0	0	10,215
Other investments	654	0	0	654	0	4	650
Total	$ 60,804	$ 3,052	$ (219)	$ 63,637	$ 9,610	$ 43,162	$ 10,865

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
December 31, 2011						
U.S. government and agency securities	**$ 1,140**	**$ (1)**	**$ 0**	**$ 0**	**$ 1,140**	**$ (1)**
Foreign government bonds	**268**	**(32)**	**0**	**0**	**268**	**(32)**
Mortgage-backed securities	**0**	**0**	**54**	**(3)**	**54**	**(3)**
Corporate notes and bonds	**1,167**	**(28)**	**32**	**(1)**	**1,199**	**(29)**
Common and preferred stock	**1,954**	**(440)**	**109**	**(38)**	**2,063**	**(478)**
Total	**$ 4,529**	**$ (501)**	**$ 195**	**$ (42)**	**$ 4,724**	**$ (543)**

	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, 2011						
U.S. government and agency securities	$ 484	$ (7)	$ 0	$ 0	$ 484	$ (7)
Foreign government bonds	365	(2)	0	0	365	(2)
Mortgage-backed securities	63	(3)	14	(1)	77	(4)
Corporate notes and bonds	750	(10)	25	(1)	775	(11)
Municipal securities	79	(2)	0	0	79	(2)
Common and preferred stock	1,377	(146)	206	(47)	1,583	(193)
Total	$ 3,118	$ (170)	$ 245	$ (49)	$ 3,363	$ (219)

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 as of December 31, 2011.

At December 31, 2011 and June 30, 2011, the recorded bases of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $433 million and $334 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
December 31, 2011		
Due in one year or less	$ 24,231	$ 24,275
Due after one year through five years	18,304	18,432
Due after five years through 10 years	3,126	3,247
Due after 10 years	2,447	2,613
Total	$ 48,108	$ 48,567

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. currency 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, and Canadian dollar. As of December 31, 2011 and June 30, 2011, the total notional amounts of these foreign exchange contracts sold were $9.4 billion and $10.6 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 December 31, 2011 and June 30, 2011, the total notional amounts of these foreign exchange contracts sold were $481 million and $572 million, respectively.

Certain options and forwards not designated as hedging instruments are also used to manage the variability in exchange rates on accounts receivable, cash, and intercompany positions, and to manage other foreign currency exposures. As of December 31, 2011, the total notional amounts of these foreign exchange contracts purchased and sold were $3.0 billion and $7.0 billion, respectively. As of June 30, 2011, the total notional amounts of these foreign exchange contracts purchased and sold were $4.3 billion and $7.1 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 December 31, 2011, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.1 billion and $779 million, respectively. As of June 30, 2011, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.1 billion and $860 million, respectively.

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 December 31, 2011, the total notional amounts of fixed-interest rate contracts purchased and sold were $1.2 billion and $846 million, respectively. As of June 30, 2011, the total notional amounts of fixed-interest rate contracts purchased and sold were $2.3 billion and $697 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 December 31, 2011 and June 30, 2011, the total notional derivative amount of mortgage contracts purchased were $1.1 billion and $868 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 December 31, 2011, the total notional amounts of credit contracts purchased and sold were $221 million and $297 million, respectively. As of June 30, 2011, the total notional amounts of credit contracts purchased and sold were $532 million and $281 million, respectively.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swap, futures and option contracts, not designated as hedging instruments, to generate and manage exposures to broad-based commodity indices. We use derivatives on commodities as they can be low-cost alternatives to the purchase and storage of a variety of commodities, including, but not limited to, precious metals, energy, and grain. As of December 31, 2011, the total notional amounts of commodity contracts purchased and sold were $1.3 billion and $458 million, respectively. As of June 30, 2011, the total notional amounts of commodity contracts purchased and sold were $1.9 billion and $502 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 a 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 December 31, 2011, 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

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 gain (loss) is recognized in earnings in the period of change together with the offsetting loss or gain 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 derivative’s gain (loss) is initially reported as a component of other comprehensive income (“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). Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities, which are recorded as a component of OCI until the securities are sold or other-than-temporarily impaired, at which time the amounts are moved from OCI into other income (expense).

The following tables present the gross 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:

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
December 31, 2011						
Assets						
Non-designated hedge derivatives:						
Short-term investments	$ 36	$ 136	$ 14	$ 27	$ 6	$ 219
Other current assets	127	0	0	0	0	127
Total	$ 163	$ 136	$ 14	$ 27	$ 6	$ 346
Designated hedge derivatives:						
Short-term investments	$ 9	$ 0	$ 0	$ 0	$ 0	$ 9
Other current assets	330	0	0	0	0	330
Total	$ 339	$ 0	$ 0	$ 0	$ 0	$ 339
Total assets	$ 502	$ 136	$ 14	$ 27	$ 6	$ 685
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	$ (108)	$ (11)	$ (22)	$ (20)	$ (3)	$ (164)
Designated hedge derivatives:						
Other current liabilities	$ (30)	$ 0	$ 0	$ 0	$ 0	$ (30)
Total liabilities	$ (138)	$ (11)	$ (22)	$ (20)	$ (3)	$ (194)

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(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
June 30, 2011						
Assets						
Non-designated hedge derivatives:						
Short-term investments	$ 14	$ 179	$ 0	$ 17	$ 4	$ 214
Other current assets	73	0	0	0	0	73
Total	$ 87	$ 179	$ 0	$ 17	$ 4	$ 287
Designated hedge derivatives:						
Short-term investments	$ 6	$ 0	$ 0	$ 0	$ 0	$ 6
Other current assets	123	0	0	0	0	123
Total	$ 129	$ 0	$ 0	$ 0	$ 0	$ 129
Total assets	$ 216	$ 179	$ 0	$ 17	$ 4	$ 416
Liabilities						
Non-designated hedge derivatives:						
Other current liabilities	$ (91)	$ (12)	$ (9)	$ (19)	$ (4)	$ (135)
Designated hedge derivatives:						
Other current liabilities	$ (128)	$ 0	$ 0	$ 0	$ 0	$ (128)
Total liabilities	$ (219)	$ (12)	$ (9)	$ (19)	$ (4)	$ (263)

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

Fair-Value Hedge Gains (Losses)

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	**2011**	2010
Foreign Exchange Contracts				
Derivatives	**$ 4**	$ 2	**$ 48**	$ (50)
Hedged items	**(5)**	(2)	**(48)**	48
Total	**$ (1)**	$ 0	**$ 0**	$ (2)

Cash Flow Hedge Gains (Losses)

We recognized the following gains (losses) on foreign exchange contracts designated as cash flow hedges (our only cash flow hedges during the periods presented):

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	**2011**	2010
Effective Portion				
Gain (loss) recognized in OCI, net of tax effect of **$33** and $(24) for the three months ended December 31, 2011 and 2010, and **$102** and $(267) for the six months ended December 31, 2011 and 2010	**$ 62**	$ (45)	**$ 190**	$ (497)
Gain (loss) reclassified from OCI into revenue	**(21)**	55	**(70)**	139
Amount Excluded from Effectiveness Assessment and Ineffective Portion				
Loss recognized in other income	**(127)**	(16)	**(65)**	(103)

We estimate that $84 million of net derivative gains included in OCI at December 31, 2011 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the three and six months ended December 31, 2011.

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). 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), which were immaterial for the periods presented. Other than those derivatives entered into for investment purposes, such as commodity contracts, the gains (losses) below are generally economically offset by unrealized gains (losses) in the underlying available-for-sale securities.

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	**2011**	2010
Foreign exchange contracts	**$ (16)**	$ (25)	**$ (65)**	$ (85)
Equity contracts	**(79)**	(2)	**(68)**	31
Interest-rate contracts	**15**	24	**58**	12
Credit contracts	**10**	10	**(7)**	28
Commodity contracts	**2**	93	**(88)**	158
Total	**$ (68)**	$ 100	**$ (170)**	$ 144

NOTE 6 FAIR VALUE MEASUREMENTS

We account for certain assets and liabilities at fair value. The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. We categorize each of our fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

- *Level 1*—inputs are based upon unadjusted quoted prices for identical instruments traded in active markets. Our Level 1 non-derivative investments primarily include U.S. treasuries, domestic and international equities, and actively traded mutual funds. Our Level 1 derivative assets and liabilities include those actively traded on exchanges.
- *Level 2*—inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and forward and spot prices for currencies and commodities. Our Level 2 non-derivative investments consist primarily of corporate notes and bonds, mortgage-backed securities, agency securities, certificates of deposit, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option and swap contracts.
- *Level 3*—inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models. Our Level 3 non-derivative assets primarily comprise investments in certain corporate bonds. We value these corporate bonds using internally developed valuation models, inputs to which include interest rate curves, credit spreads, stock prices, and volatilities. Unobservable inputs used in these models are significant to the fair values of the investments. Our Level 3 derivative assets and liabilities primarily comprise derivatives for foreign equities. In certain cases, market-based observable inputs are not available and we use management judgment to develop assumptions to determine fair value for these derivatives.

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.

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
December 31, 2011						
Assets						
Mutual funds	**$ 816**	**$ 0**	**$ 0**	**$ 816**	**$ 0**	**$ 816**
Commercial paper	**0**	**465**	**0**	**465**	**0**	**465**
Certificates of deposit	**0**	**1,003**	**0**	**1,003**	**0**	**1,003**
U.S. government and agency securities	**23,240**	**8,467**	**0**	**31,707**	**0**	**31,707**
Foreign government bonds	**178**	**692**	**0**	**870**	**0**	**870**
Mortgage-backed securities	**0**	**2,010**	**0**	**2,010**	**0**	**2,010**
Corporate notes and bonds	**0**	**11,898**	**9**	**11,907**	**0**	**11,907**
Municipal securities	**0**	**457**	**0**	**457**	**0**	**457**
Common and preferred stock	**6,354**	**49**	**5**	**6,408**	**0**	**6,408**
Derivatives	**5**	**680**	**0**	**685**	**(185)**	**500**
Total	**$ 30,593**	**$ 25,721**	**$ 14**	**$ 56,328**	**$ (185)**	**$ 56,143**
Liabilities						
Derivatives and other	**$ 4**	**$ 190**	**$ 0**	**$ 194**	**$ (182)**	**$ 12**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[(a)]	Net Fair Value
June 30, 2011						
Assets						
Mutual funds	$ 1,752	$ 0	$ 0	$ 1,752	$ 0	$ 1,752
Commercial paper	0	639	0	639	0	639
Certificates of deposit	0	598	0	598	0	598
U.S. government and agency securities	23,591	10,175	0	33,766	0	33,766
Foreign government bonds	303	367	0	670	0	670
Mortgage-backed securities	0	2,428	0	2,428	0	2,428
Corporate notes and bonds	0	10,600	58	10,658	0	10,658
Municipal securities	0	454	0	454	0	454
Common and preferred stock	9,821	55	5	9,881	0	9,881
Derivatives	8	388	20	416	(204)	212
Total	$ 35,475	$ 25,704	$ 83	$ 61,262	$ (204)	$ 61,058
Liabilities						
Derivatives and other	$ 109	$ 257	$ 0	$ 366	$ (203)	$ 163

(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 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)	December 31, 2011	June 30, 2011
Net fair value of assets measured at fair value on a recurring basis	**$ 56,143**	$ 61,058
Cash	**2,349**	1,648
Common and preferred stock measured at fair value on a nonrecurring basis	**433**	334
Other investments measured at fair value on a nonrecurring basis	**710**	650
Less derivative assets classified as other current assets	**(350)**	(54)
Other	**1**	1
Recorded basis of investment components	**$ 59,286**	$ 63,637

Changes in Financial Instruments Measured at Level 3 Fair Value on a Recurring Basis

The following tables present the changes during the periods presented in our Level 3 financial instruments that are measured at fair value on a recurring basis. The majority of these instruments consist of investment securities classified as available-for-sale with changes in fair value included in OCI.

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three and Six Months Ended December 31, 2011				
Balance as of June 30, 2011	**$ 58**	**$ 5**	**$ 20**	**$ 83**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**0**	**0**	**(2)**	**(2)**
Included in other comprehensive income	**(21)**	**0**	**0**	**(21)**
Balance as of September 30, 2011	**$ 37**	**$ 5**	**$ 18**	**$ 60**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**0**	**0**	**(3)**	**(3)**
Included in other comprehensive income	**0**	**0**	**0**	**0**
Conversions of Level 3 instruments to Level 1 instruments	**(28)**	**0**	**(15)**	**(43)**
Balance as of December 31, 2011	**$ 9**	**$ 5**	**$ 0**	**$ 14**
Change in unrealized gains (losses) included in other income (expense) for the three months ended December 31, 2011 related to assets held as of December 31, 2011	**$ 0**	**$ 0**	**$ 0**	**$ 0**
Change in unrealized gains (losses) included in other income (expense) for the six months ended December 31, 2011 related to assets held as of December 31, 2011	**$ 0**	**$ 0**	**$ 0**	**$ 0**

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three and Six Months Ended December 31, 2010				
Balance as of June 30, 2010	$ 167	$ 5	$ 9	$ 181
Total realized and unrealized gains (losses):				
Included in other income (expense)	2	0	7	9
Included in other comprehensive income	(2)	0	0	(2)
Balance as of September 30, 2010	$ 167	$ 5	$ 16	$ 188
Total realized and unrealized gains (losses):				
Included in other income (expense)	2	0	(1)	1
Included in other comprehensive income	2	0	0	2
Balance as of December 31, 2010	$ 171	$ 5	$ 15	$ 191
Change in unrealized gains (losses) included in other income (expense) for the three months ended December 31, 2010 related to assets held as of December 31, 2010	$ 2	$ 0	$ (1)	$ 1
Change in unrealized gains (losses) included in other income (expense) for the six months ended December 31, 2010 related to assets held as of December 31, 2010	$ 4	$ 0	$ 6	$ 10

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

During the three and six months ended December 31, 2011 and 2010, we did not record any other-than-temporary impairments on those assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)	December 31, 2011	June 30, 2011
Raw materials	**$ 243**	$ 232
Work in process	**81**	56
Finished goods	**1,027**	1,084
Total	**$ 1,351**	$ 1,372

NOTE 8 BUSINESS COMBINATIONS

On October 13, 2011, we acquired all of the issued and outstanding shares of Skype Global S.á r.l. (“Skype”), a leading global provider of software applications and related Internet communications products based in Luxembourg, for $8.6 billion primarily in cash. Our purchase price allocations are preliminary and subject to revision as more detailed analyses are completed and additional information about fair value of assets and liabilities becomes available, including additional information relating to tax matters and finalization of our valuation of identified intangible assets. The major classes of assets and liabilities to which we preliminarily allocated the purchase price were: goodwill of $7.1 billion; identifiable intangible assets of $1.6 billion with a weighted average estimated useful life of 13 years, primarily marketing-related (trade name) and technology-based intangibles with estimated useful lives of 15 years and 5 years, respectively; and unearned revenue of $222 million. The goodwill recognized in connection with the acquisition is primarily attributable to our expectation of extending Skype’s brand and the reach of its networked platform, while enhancing Microsoft’s existing portfolio of real-time communications products and services. We preliminarily assigned the goodwill to the following segments: $4.2 billion to Entertainment and Devices Division, $2.8 billion to Microsoft Business Division, and $54 million to Online Services Division. Skype was consolidated into our results of operations starting October 13, 2011, the acquisition date.

During the first six months of fiscal year 2012, we completed an additional three acquisitions for total consideration of $83 million, substantially all of which was paid in cash.

Pro forma results of operations have not been presented because the effects of the business combinations described in this Note, individually and in aggregate, were not material to our consolidated results of operations.

NOTE 9 GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)	Balance as of September 30, 2011	Acquisitions	Other	Balance as of December 31, 2011
Windows & Windows Live Division	$ 89	**$ 0**	**$ 0**	**$ 89**
Server and Tools	1,144	**0**	**0**	**1,144**
Online Services Division	6,373	**54**	**0**	**6,427**
Microsoft Business Division	4,119	**2,843**	**(35)**	**6,927**
Entertainment and Devices Division	812	**4,272**	**(1)**	**5,083**
Total	$ 12,537	**$ 7,169**	**$ (36)**	**$ 19,670**

(In millions)	Balance as of June 30, 2011	Acquisitions	Other	Balance as of December 31, 2011
Windows & Windows Live Division	$ 89	**$ 0**	**$ 0**	**$ 89**
Server and Tools	1,139	**7**	**(2)**	**1,144**
Online Services Division	6,373	**54**	**0**	**6,427**
Microsoft Business Division	4,167	**2,843**	**(83)**	**6,927**
Entertainment and Devices Division	813	**4,272**	**(2)**	**5,083**
Total	$ 12,581	**$ 7,176**	**$ (87)**	**$ 19,670**

We do not expect any of the amounts recorded as goodwill to be deductible for tax purposes. The measurement period for purchase price allocations ends as soon as information on the facts and circumstances becomes available, but will not exceed 12 months. Adjustments in the purchase price allocation may require a recasting of the amounts allocated to goodwill retroactive to the period in which the acquisition occurred. Any change in the goodwill amounts resulting from foreign currency translations are presented as “other” in the above table. Also included within “other” are transfers between business segments due to reorganizations, as applicable.

NOTE 10 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
			December 31, 2011			**June 30, 2011**
Technology-based[(a)]	**$ 2,965**	**$ (2,012)**	**$ 953**	$ 2,356	$ (1,831)	$ 525
Marketing-related	**1,361**	**(122)**	**1,239**	113	(98)	15
Contract-based	**1,190**	**(990)**	**200**	1,068	(966)	102
Customer-related	**440**	**(251)**	**189**	326	(224)	102
Total	**$ 5,956**	**$ (3,375)**	**$ 2,581**	$ 3,863	$ (3,119)	$ 744

(a) *Technology-based intangible assets included $150 million and $179 million as of December 31, 2011 and June 30, 2011, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

Intangible assets amortization expense was $155 million and $264 million for the three and six months ended December 31, 2011, respectively, as compared with $126 million and $250 million for the three and six months ended December 31, 2010, respectively. Amortization of capitalized software was $28 million and $57 million for the three and six months ended December 31, 2011, respectively, and $30 million and $56 million for the three and six months ended December 31, 2010, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held at December 31, 2011:

(In millions)	
Year Ending June 30,	
2012 (excluding the six months ended December 31, 2011)	$ 284
2013	480
2014	314
2015	260
2016	216
Thereafter	1,027
Total	$ 2,581

NOTE 11 DEBT

As of December 31, 2011, the total carrying value and estimated fair value of our long-term debt, including convertible debt, were $11.9 billion and $13.1 billion, respectively. This is compared to a carrying value and estimated fair value of $11.9 billion and $12.1 billion, respectively, as of June 30, 2011. The estimated fair value is based on quoted prices for our publicly-traded debt as of December 31, 2011 and June 30, 2011, as applicable.

The components of long-term debt, the associated interest rates, and the semi-annual interest record and payment dates were as follows as of December 31, 2011:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate	Interest Record Date	Interest Pay Date	Interest Record Date	Interest Pay Date
	(In millions)						
Notes							
September 27, 2013	$ 1,000	0.875%	1.000%	March 15	March 27	September 15	September 27
June 1, 2014	2,000	2.950%	3.049%	May 15	June 1	November 15	December 1
September 25, 2015	1,750	1.625%	1.795%	March 15	March 25	September 15	September 25
February 8, 2016	750	2.500%	2.642%	February 1	February 8	August 1	August 8
June 1, 2019	1,000	4.200%	4.379%	May 15	June 1	November 15	December 1
October 1, 2020	1,000	3.000%	3.137%	March 15	April 1	September 15	October 1
February 8, 2021	500	4.000%	4.082%	February 1	February 8	August 1	August 8
June 1, 2039	750	5.200%	5.240%	May 15	June 1	November 15	December 1
October 1, 2040	1,000	4.500%	4.567%	March 15	April 1	September 15	October 1
February 8, 2041	1,000	5.300%	5.361%	February 1	February 8	August 1	August 8
Total	10,750						
Convertible Debt							
June 15, 2013	1,250	0.000%	1.849%				
Total unamortized discount	(68)						
Total	$ 11,932						

The components of long-term debt, the associated interest rates, and the semi-annual interest record and payment dates were as follows as of June 30, 2011:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate	Interest Record Date	Interest Pay Date	Interest Record Date	Interest Pay Date
	(In millions)						
Notes							
September 27, 2013	$ 1,000	0.875%	1.000%	March 15	March 27	September 15	September 27
June 1, 2014	2,000	2.950%	3.049%	May 15	June 1	November 15	December 1
September 25, 2015	1,750	1.625%	1.795%	March 15	March 25	September 15	September 25
February 8, 2016	750	2.500%	2.642%	February 1	February 8	August 1	August 8
June 1, 2019	1,000	4.200%	4.379%	May 15	June 1	November 15	December 1
October 1, 2020	1,000	3.000%	3.137%	March 15	April 1	September 15	October 1
February 8, 2021	500	4.000%	4.082%	February 1	February 8	August 1	August 8
June 1, 2039	750	5.200%	5.240%	May 15	June 1	November 15	December 1
October 1, 2040	1,000	4.500%	4.567%	March 15	April 1	September 15	October 1
February 8, 2041	1,000	5.300%	5.361%	February 1	February 8	August 1	August 8
Total	10,750						
Convertible Debt							
June 15, 2013	1,250	0.000%	1.849%				
Total unamortized discount	(79)						
Total	$ 11,921						

Notes

The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Each $1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share. As of December 31, 2011, the net carrying amount of our convertible debt was $1.2 billion and the unamortized discount was $28 million.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft's common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of $1.24 billion were allocated between debt for $1.18 billion and stockholders' equity for $58 million with the portion in stockholders' equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with a cap price equal to $37.16. The purchased capped calls were valued at $40 million and recorded to stockholders' equity.

NOTE 12 INCOME TAXES

Our effective tax rates were approximately 20% and 22% for the three months ended December 31, 2011 and 2010, respectively, and 20% and 23% for the six months ended December 31, 2011 and 2010, respectively. Our effective tax rate was lower than the U.S. federal statutory rate and prior year effective rates primarily due to a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico, which are subject to lower income tax rates.

Tax contingencies and other tax liabilities were $7.7 billion and $7.4 billion as of December 31, 2011 and June 30, 2011, respectively, and are included in other long-term liabilities. While we settled a portion of the I.R.S. audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, we remain under audit for these years. During the fourth quarter of fiscal year 2011, the I.R.S. completed its examination and issued a Revenue Agent's Report ("RAR") for the remaining unresolved items. We do not agree with the adjustments in the RAR, and we have filed a protest to initiate the administrative appeals process. The proposed adjustments are primarily related to transfer pricing and could have a significant impact on our financial statements if not resolved favorably. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the appeals process will be concluded within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2011.

We are subject to income tax in many jurisdictions outside the U.S. Certain jurisdictions remain subject to examination for tax years 1996 to 2010, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our financial statements.

NOTE 13 UNEARNED REVENUE

The components of unearned revenue were as follows:

(In millions)

	December 31, 2011	June 30, 2011
Volume licensing programs	**$ 12,873**	$ 14,625
Other	**2,461**	2,495
Total	**$ 15,334**	$ 17,120

Unearned revenue by segment was as follows:

(In millions)

	December 31, 2011	June 30, 2011
Windows & Windows Live Division	**$ 1,525**	$ 1,782
Server and Tools	**5,612**	6,315
Microsoft Business Division	**7,085**	8,187
Other segments	**1,112**	836
Total	**$ 15,334**	$ 17,120

Fiscal year 2011 amounts have been recast for the fiscal year 2012 movement of Forefront Protection for Office, an anti-malware solution, from Server and Tools to the Microsoft Business Division.

NOTE 14 COMMITMENTS AND GUARANTEES

Yahoo! Commercial Agreement

On December 4, 2009, we entered into a 10-year agreement with Yahoo! whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. Microsoft provided Yahoo! with revenue per search guarantees for a period of 18 months after implementation of the Microsoft search ads platform in each country, extended by an additional 12 months for the U.S. and Canada. These guarantees are calculated, paid, and adjusted periodically and are rate guarantees, not guarantees of search volume. We estimate the remaining cost of the revenue per search guarantees during the guarantee period could range up to $150 million. Microsoft also agreed to reimburse Yahoo! for certain costs of running algorithmic and paid search services prior to migration to Microsoft's platform.

Product Warranty

The changes in our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities on our balance sheets were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	**2011**	2010
Balance, beginning of period	**$ 166**	$ 214	**$ 172**	$ 240
Accruals for warranties issued	**19**	19	**31**	32
Settlements of warranty claims	**(18)**	(31)	**(36)**	(70)
Balance, end of period	**$ 167**	$ 202	**$ 167**	$ 202

NOTE 15 CONTINGENCIES

Antitrust, Unfair Competition, and Overcharge Class Actions

A large number of antitrust and unfair competition class action lawsuits were filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals or reached settlements of all claims that have been made to date in the United States.

All settlements in the United States have received final court approval. Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers. We estimate the total cost to resolve all of the state overcharge class action cases will range between $1.9 billion and $2.0 billion. At December 31, 2011, we have recorded a liability related to these claims of approximately $524 million, which reflects our estimated exposure of $1.9 billion less payments made to date of approximately $1.4 billion mostly for vouchers, legal fees, and administrative expenses.

The three cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In March 2010, the court in the British Columbia case certified it as a class action. On April 15, 2011, the British Columbia Court of Appeal reversed the class certification ruling and dismissed the case, holding that indirect purchasers do not have a claim. The plaintiffs have appealed to the Canadian Supreme Court. The other two actions have been stayed.

Other Antitrust Litigation and Claims

In November 2004, Novell, Inc. ("Novell") filed a complaint in U.S. District Court for the District of Utah (later transferred to federal court in Maryland), asserting antitrust and unfair competition claims against us related to Novell's ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. In March 2010, the trial court granted summary judgment in favor of Microsoft as to all remaining claims. The court of appeals reversed that ruling. Trial on the case took place in October 2011 and resulted in a mistrial because the jury was unable to reach a verdict. Microsoft expects to file a motion for judgment as a matter of law. The court has not set a new trial date.

Patent and Intellectual Property Claims

In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents (although this action began before the merger of Alcatel and Lucent in 2006, for simplicity we refer to the post-merger entity of Alcatel-Lucent). In April 2008, a jury returned a verdict in Alcatel-Lucent's favor in a trial on a consolidated group of one video and three user interface patents. The jury concluded that we had infringed two user interface patents and awarded $367 million in damages. In June 2008, the trial judge increased the amount of damages to $512 million to include $145 million of interest. We appealed that award. In December 2008, we entered into a settlement agreement resolving all other litigation pending between Microsoft and Alcatel-Lucent, leaving approximately $500 million remaining in dispute. In September 2009, the court of appeals affirmed the liability award but vacated the verdict and remanded the case to the trial court for a re-trial of the damages ruling, indicating the damages previously awarded were too high. Trial on the remanded damages claim was held in July 2011 and the jury awarded Alcatel-Lucent $70 million. We filed a motion for judgment as a matter of law, which the court granted in part, and reduced the judgment to $26 million, not including post-trial interest, which would have increased the judgment to approximately $41 million. Alcatel-Lucent appealed the court's decision, and Microsoft cross-appealed. The parties have now entered into a confidential settlement agreement to resolve the matter.

In October 2003, Uniloc USA Inc. ("Uniloc"), a subsidiary of a Singapore-based company, filed a patent infringement suit in U.S. District Court in Rhode Island, claiming that product activation technology supporting Windows XP and certain other Microsoft programs violated a Uniloc patent. After we obtained a favorable summary judgment that we did not infringe any of the claims of this patent, the court of appeals vacated the trial court decision and remanded the case for trial. In April 2009, the jury returned a $388 million verdict against us, including a finding of willful infringement. In September 2009, the district court judge overturned the jury verdict, ruling that the evidence did not support the jury's findings either that Microsoft infringed the patent or was willful. Uniloc appealed, and in January 2011 the court of appeals reversed the district court's finding of non-infringement (thus reinstating the jury verdict of infringement) but affirmed the district court's ruling that Microsoft was not willful and affirmed the district court's grant of a new trial on damages. Uniloc's petition for rehearing of the court of appeals' decision as to damages was denied. A new trial on damages has been set for February 2012.

In October 2010, we filed suit against Motorola with the International Trade Commission ("ITC") and in U.S. District Court in Washington for infringement of nine Microsoft patents by Motorola's Android-based devices. Since then, Microsoft and Motorola have filed additional actions against each other in the ITC and federal courts in Washington, Wisconsin, Florida, California and Germany. Microsoft asserts Motorola's Android-based devices violate 28 of its patents, and Motorola asserts various Microsoft products (including Windows, Windows Phone 7, Windows Mobile 6.5, Xbox, Bing Maps, Hotmail, Messenger, and Exchange Server) violate 24 Motorola patents. Microsoft also claims Motorola has breached its contractual commitments to the Institute of Electrical and Electronics Engineers and International Telecommunications Union to license identified patents related to wireless and video coding technologies under reasonable and non-discriminatory ("RAND") terms and conditions. In the case originally filed in California, Motorola asserts that Microsoft breached contractual commitments to the SD Card Association to license two patents under RAND terms and conditions, and asserts federal antitrust and state unfair business practice claims. Trial in our ITC case took place in August 2011. In December 2011, the administrative law judge issued an initial determination that Motorola infringed one Microsoft patent, and recommended that the ITC issue a limited exclusion order against Motorola. The ITC's ruling is expected in April 2012. Trial in Motorola's ITC case is set for January 2012. All of the cases pending in Wisconsin, California and Florida, with the exception of one currently stayed case in Wisconsin, have been transferred to the Western District of Washington. The lawsuits filed in Germany by Motorola and Microsoft all allege patent infringement. A hearing in one of our German actions against Motorola took place in December 2011. Additional hearings are scheduled on Microsoft's claims against Motorola in Germany in February, March, April, and June 2012. Motorola's German actions against Microsoft are scheduled for trial in January and March 2012.

In addition to these cases, there are approximately 60 other patent infringement cases pending against Microsoft.

Other

We also are subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

As of December 31, 2011, we had accrued aggregate liabilities of $411 million in other current liabilities and $295 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, adverse outcomes that we estimate could reach approximately $560 million in aggregate beyond recorded amounts are reasonably possible. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.

NOTE 16 STOCKHOLDERS' EQUITY

Share Repurchases

We repurchased the following shares of common stock during the periods presented:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
Shares of common stock repurchased	**39**	188	**78**	351
Value of common stock repurchased	**$ 1,000**	$ 5,000	**$ 2,000**	$ 9,000

We repurchased all shares with cash resources. As of December 31, 2011, approximately $10.2 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal Year 2012				
September 20, 2011	**$ 0.20**	**November 17, 2011**	**$ 1,683**	**December 8, 2011**
December 14, 2011	**$ 0.20**	**February 16, 2012**	**$ 1,676**	**March 8, 2012**
Fiscal Year 2011				
September 21, 2010	$ 0.16	November 18, 2010	$ 1,363	December 9, 2010
December 15, 2010	$ 0.16	February 17, 2011	$ 1,349	March 10, 2011

The estimate of the amount to be paid as a result of the December 14, 2011 declaration was included in other current liabilities as of December 31, 2011.

NOTE 17 SEGMENT INFORMATION

In its operation of the business, management, including our chief operating decision maker, the Company's Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segment information within this note is reported on that basis. Our five segments are Windows & Windows Live Division; Server and Tools; Online Services Division; Microsoft Business Division; and Entertainment and Devices Division.

Due to the integrated structure of our business, certain revenue earned and costs incurred by one segment may benefit other segments. Revenue on certain contracts may be allocated among the segments based on the relative value of the underlying products and services. Costs that are identifiable are allocated to the segments that benefit to incent cross-collaboration among our segments so that one segment is not solely burdened by the cost of a mutually beneficial activity. Allocated costs may include those relating to development and marketing of products and services from which multiple segments benefit, or those costs relating to services performed by one segment on behalf of other segments. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated.

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: field selling; employee benefits; 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 other corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; legal settlements and contingencies; and employee severance.

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We have recast certain prior period amounts within this note to conform to the way we internally managed and monitored segment performance during the current fiscal year, including moving Forefront Protection for Office, an anti-malware solution, from Server and Tools to the Microsoft Business Division, as well as conforming management reporting and U.S. GAAP reporting for stock-based compensation.

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

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Revenue				
Windows & Windows Live Division	**$ 4,709**	$ 4,988	**$ 9,541**	$ 9,694
Server and Tools	**4,775**	4,291	**9,026**	8,154
Online Services Division	**798**	729	**1,456**	1,292
Microsoft Business Division	**6,265**	5,890	**11,855**	11,063
Entertainment and Devices Division	**4,237**	3,728	**6,205**	5,507
Unallocated and other	**101**	327	**174**	438
Consolidated	**$ 20,885**	$ 19,953	**$ 38,257**	$ 36,148
Operating Income (Loss)				
Windows & Windows Live Division	**$ 2,825**	$ 3,148	**$ 6,044**	$ 6,360
Server and Tools	**2,003**	1,723	**3,608**	3,271
Online Services Division	**(455)**	(557)	**(968)**	(1,121)
Microsoft Business Division	**4,137**	3,865	**7,811**	7,321
Entertainment and Devices Division	**530**	706	**888**	1,088
Reconciling amounts	**(1,046)**	(720)	**(2,186)**	(1,638)
Consolidated	**$ 7,994**	$ 8,165	**$ 15,197**	$ 15,281

Reconciling amounts in the tables above and below include adjustments to conform our internal accounting policies to U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, and depreciation.

Significant reconciling items were as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Corporate-level activity[(a)]	**$ (1,074)**	$ (954)	**$ (2,242)**	$ (1,957)
Revenue reconciling amounts	**24**	239	**52**	347
Other	**4**	(5)	**4**	(28)
Total	**$ (1,046)**	$ (720)	**$ (2,186)**	$ (1,638)

(a) *Corporate-level activity excludes revenue reconciling amounts presented separately in that line item.*

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 and 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.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the "Corporation") as of December 31, 2011, and the related consolidated statements of income, cash flows, and stockholders' equity for the three-month and six-month periods ended December 31, 2011 and 2010. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2011, and the related consolidated statements of income, cash flows, and stockholders' equity for the year then ended (not presented herein); and in our report dated July 28, 2011 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2011 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington

January 19, 2012

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Note About Forward-Looking Statements

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, 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 without limitation, the following sections: "Management's Discussion and Analysis," and "Risk Factors." 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 which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled "Risk Factors" (Part II, Item 1A of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

OVERVIEW

The following management's discussion and analysis ("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 Annual Report on Form 10-K for the year ended June 30, 2011 and our financial statements and accompanying Notes to Financial Statements.

Microsoft is a technology leader focused on helping people and businesses throughout the world realize their full potential. We create technology that transforms the way people work, play, and communicate across a wide range of computing devices.

We generate revenue by developing, licensing, and supporting a wide range of software products and services, by designing and selling hardware, and by delivering relevant online advertising to a global customer audience. Our most significant expenses are related to compensating employees, designing, manufacturing, marketing and selling our products and services, and income taxes.

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 which can further transform the industry and our business. At Microsoft, we push the boundaries of what is possible through a broad set of research and technology innovations that seek to anticipate the changing demands of customers, industry trends, and competitive forces.

Key Opportunities and Investments

Based on our assessment of key technology trends and our broad focus on long-term research and development of new products and services, we see significant opportunities to drive future growth.

Smart connected devices

The price per unit of processing, storage, and networks continues to decline while at the same time devices increase in capability. As a result, the capabilities and accessibility of PCs, mobile, and other devices powered by rich software platforms and applications continue to grow. At the same time, the information and services people use increasingly span multiple devices. User experiences will be transformed by the adoption of cloud computing when brought together with the richness of smart, connected devices. Microsoft is delivering experiences that seamlessly connect PCs and mobile and other devices through the cloud. We are devoting significant resources to consumer cloud offerings like Bing, Windows Live, and Xbox LIVE. Our software and hardware platform investments can be seen in products like Kinect, Windows, Windows Azure, Windows Phone, Windows Server, and Xbox.

Cloud computing transforming the data center and information technology

Cloud-based solutions provide customers with software, services and content over the Internet by way of shared computing resources located in centralized data centers. Computing is undergoing a long-term shift from client/server to the cloud, a shift similar in importance and impact to the transition from mainframe to client/server. The shift to the cloud is driven by three important economies of scale: larger data centers can deploy computational resources at significantly lower cost per unit than smaller ones; larger data centers can coordinate and aggregate diverse customer, geographic, and application demand patterns which can improve the utilization of computing, storage, and network resources; and multi-tenancy lowers application maintenance labor costs for large public clouds. As a result of the improved economics, the cloud offers unique levels of elasticity and agility that will enable new solutions and applications. For businesses of all sizes, the cloud creates the opportunity to focus more on innovation while leaving non-differentiating activities to reliable and cost-effective providers. For many businesses, the first step in achieving cloud economics is the adoption of virtualization in their data center. We are devoting significant resources to developing cloud infrastructure, platforms, and applications including offerings such as Microsoft Dynamics Online, Microsoft SQL Azure, Office 365, Windows Azure, Windows Intune, and Windows Server.

Entertainment

The evolution of hardware, software, services, and the cloud are enhancing the delivery and quality of unified entertainment experiences across many devices. These rich media experiences include games, movies, music, television, and social interactions with family, friends, and colleagues. At Microsoft, our approach is to simplify and increase the accessibility of these entertainment experiences to broaden market penetration of our software and services. We invest significant resources to develop or partner to develop hardware, software, and content that is used in products and services such as Windows Phone, Xbox, Xbox LIVE, and Skype.

Search

Over the last two decades, web content and social connections have increased dramatically as people spend more time online, while discoverability and accessibility has been transforming from direct navigation and document links. There is significant opportunity to deliver differentiated products that helps users make better decisions and complete tasks more simply when using PC, mobile, and other devices. Our approach is to use machine learning to try to understand user intent, and differentiate our product by focusing on the integration of visual, social, and other elements which simplifies people's interaction with the Internet. We invest significant resources in Bing, SharePoint, Windows, Windows Phone, and Xbox LIVE.

Communications and productivity

Personal and business productivity has been transformed by the ubiquity of computing and software tools. Over the last decade, Microsoft redefined software productivity beyond the rich Office client on the PC. Productivity scenarios now encompass unified communications, business intelligence, collaboration, content management, and relationship management, which are increasingly powered by server-side applications. These server applications can be hosted by the customer, a partner, or by Microsoft in the cloud. There are significant opportunities to provide productivity and communication scenarios across PCs, mobile devices, and other devices that connect to services. We invest significant resources in Dynamics, Exchange, Lync, Skype, Office, Office 365, SharePoint, and Windows Live.

Economic Conditions, Challenges and Risks

As discussed above, our industry is dynamic and highly competitive. We must anticipate changes in technology and business models. Our model for growth is based on our ability to initiate and embrace disruptive technology trends, to enter new markets, both in terms of geographies and product areas, and to drive broad adoption of the products and services we develop and market.

At Microsoft, we prioritize our investments among the highest long-term growth opportunities. These investments require significant resources and are multi-year in nature. The products and services we bring to market can be built internally, brought to market as part of a partnership or alliance, or through acquisition.

Our success is highly dependent on our ability to attract and retain qualified employees. We rely on hiring from a mix of university and industry talent worldwide. Microsoft competes for talented individuals worldwide by offering broad customer reach, scale in resources, and competitive compensation.

Demand for our software, services, and hardware has a strong correlation to global macroeconomic factors. The current macroeconomic factors remain dynamic. See a discussion of these factors and other risks under Risk Factors (Part II, Item 1A. of this Form 10-Q).

Seasonality

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated approximately 40% of its yearly segment revenue in our second fiscal quarter. In addition, quarterly revenue may be impacted by the deferral of revenue. See the discussions below regarding sales of earlier versions of the Microsoft Office system with a guarantee to be upgraded to the newest version of the Microsoft Office system at minimal or no cost (the “Office Deferral”).

RESULTS OF OPERATIONS

Summary

(In millions, except percentages and per share amounts)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Revenue	**$ 20,885**	$ 19,953	5%	**$ 38,257**	$ 36,148	6%
Operating income	**$ 7,994**	$ 8,165	(2)%	**$ 15,197**	$ 15,281	(1)%
Diluted earnings per share	**$ 0.78**	$ 0.77	1%	**$ 1.46**	$ 1.39	5%

Three months ended December 31, 2011 compared with three months ended December 31, 2010

Revenue increased primarily due to strong sales of Server and Tools products, the Xbox 360 entertainment platform, and the 2010 Microsoft Office system, offset in part by a decline in sales of PCs to consumers. Revenue for the three months ended December 31, 2011 also included Skype revenue from the date of acquisition and a favorable foreign currency impact of $225 million.

Operating income decreased reflecting higher operating expenses, offset in part by revenue growth. Key changes in operating expenses were:

- Cost of revenue increased $805 million or 17%, primarily reflecting higher volumes of Xbox 360 consoles sold and increased Xbox royalty costs, higher costs associated with providing Server and Tools products and services, payments made to Nokia related to joint strategic initiatives, and increased costs associated with our online offerings, including traffic acquisition costs.
- Research and development expenses increased $186 million or 9%, due mainly to higher headcount-related expenses.
- General and administrative expenses increased $175 million or 19%, due mainly to Puerto Rican excise taxes, higher headcount-related expenses, and increased legal costs.

Headcount-related expenses increased across the company reflecting annual increases in pay and bonuses, changes in our employee compensation program, and a 4% increase in headcount from December 31, 2010. Diluted earnings per share increased reflecting increased net income and the repurchase of 174 million shares during the 12 months ended December 31, 2011.

Six months ended December 31, 2011 compared with six months ended December 31, 2010

Revenue increased primarily due to strong sales of Server and Tools products, the Xbox 360 entertainment platform, and the 2010 Microsoft Office system, offset in part by a decline in sales of PCs to consumers. Revenue for the six months ended December 31, 2011 also included Skype revenue from the date of acquisition and a favorable foreign currency impact of $635 million.

Operating income decreased slightly reflecting higher operating expenses, offset in part by revenue growth. Key changes in operating expenses were:

- Cost of revenue increased $1.4 billion or 18%, primarily due to higher Xbox royalty costs, higher costs associated with providing Server and Tools products and services, increased costs associated with our online offerings, including traffic acquisition costs, and payments made to Nokia related to joint strategic initiatives.
- General and administrative expenses increased $400 million or 21%, due mainly to Puerto Rican excise taxes, higher headcount-related expenses, and increased legal costs.
- Research and development expenses increased $319 million or 7%, due mainly to higher headcount-related expenses.

Headcount-related expenses increased across the company reflecting annual increases in pay and bonuses, changes in our employee compensation program, and a 4% increase in headcount from December 31, 2010. Diluted earnings per share increased reflecting increased net income and the repurchase of 174 million shares during the 12 months ended December 31, 2011.

SEGMENT PRODUCT REVENUE/OPERATING INCOME (LOSS)

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the U.S. ("U.S. GAAP") and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 17 – Segment Information of the Notes to Financial Statements (Part I, Item I of this Form 10-Q) is presented on a basis consistent with our current internal management reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately. We have recast certain prior period amounts within this MD&A to conform to the way we internally managed and monitored segment performance during the current fiscal year, including moving Forefront Protection for Office, an anti-malware solution, from Server and Tools to the Microsoft Business Division.

Windows & Windows Live Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Revenue	**$ 4,736**	$ 5,056	(6)%	**$ 9,604**	$ 9,843	(2)%
Operating income	**$ 2,850**	$ 3,214	(11)%	**$ 6,101**	$ 6,502	(6)%

Windows & Windows Live Division ("Windows Division") develops and markets PC operating systems, related software and online services, and PC hardware products. This collection of software, hardware, and services is designed to simplify everyday tasks through efficient browsing capabilities and seamless operations across the user's hardware and software. Windows Division offerings consist of multiple editions of the Windows operating system, software and services through Windows Live, and Microsoft PC hardware products.

Windows Division revenue is largely correlated to the PC market worldwide, as approximately 75% of total Windows Division revenue comes from Windows operating system software purchased by original equipment manufacturers ("OEMs") which they pre-install on equipment they sell. The remaining approximately 25% of Windows Division revenue is generated by commercial and retail sales of Windows and PC hardware products and online advertising from Windows Live.

Three months ended December 31, 2011 compared with three months ended December 31, 2010

Windows Division revenue reflected relative performance in PC market segments. We estimate that sales of PCs to businesses grew approximately 2% and sales of PCs to consumers declined approximately 6%. Excluding a decline in sales of netbooks, we estimate that sales of PCs to consumers grew approximately 2%. Taken together, the total PC market decreased an estimated 2% to 4%, including the impact of supply chain issues from the Thailand floods. Windows Division revenue was also negatively impacted by a reduction in inventory levels within our distribution channels as well as by the effect of higher growth in emerging markets, where average selling prices are lower, relative to developed markets, and by lower recognition of previously deferred Windows XP revenue.

Windows Division operating income decreased primarily because of lower revenue and higher research and development expenses. Research and development expenses increased due mainly to an increase in headcount-related costs and product development costs associated with the next version of the Windows operating system.

Six months ended December 31, 2011 compared with six months ended December 31, 2010

Windows Division revenue reflected relative performance in PC market segments. We estimate that sales of PCs to businesses grew approximately 5% and sales of PCs to consumers declined approximately 2%. Excluding a decline in sales of netbooks, we estimate that sales of PCs to consumers grew approximately 5%. Taken together, the total PC market remained flat. Windows Division revenue was negatively impacted by higher growth in emerging markets, where average selling prices are lower, relative to developed markets, and by lower recognition of previously deferred Windows XP revenue.

Windows Division operating income decreased because of lower revenue and higher operating expenses, primarily research and development expenses associated with the next version of the Windows operating system.

Server and Tools

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	2010		2011	2010	
Revenue	**$ 4,772**	$ 4,288	11%	**$ 9,022**	$ 8,149	11%
Operating income	**$ 1,996**	$ 1,711	17%	**$ 3,593**	$ 3,248	11%

Server and Tools develops and markets technology and related services that enable information technology professionals and their systems to be more productive and efficient. Server and Tools product and service offerings include Windows Server, Microsoft SQL Server, Windows Azure, Visual Studio, System Center products, Windows Embedded device platforms, and Enterprise Services. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. We also offer developer tools, training and certification. Approximately 50% of Server and Tools revenue comes primarily from multi-year volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

Three months ended December 31, 2011 compared with three months ended December 31, 2010

Server and Tools revenue increased reflecting growth in both product sales and Enterprise Services. Product revenue increased $328 million or 10%, driven primarily by growth in SQL Server, Windows Server, Enterprise CAL Suites, and System Center, reflecting continued adoption of Windows platform applications. Enterprise Services revenue grew in both Premier product support and consulting services.

Server and Tools operating income increased primarily due to revenue growth, offset in part by higher costs of providing products and services.

Six months ended December 31, 2011 compared with six months ended December 31, 2010

Server and Tools revenue increased $873 million or 11%, reflecting growth in SQL Server, Windows Server, Enterprise CAL Suites, System Center, and Enterprise Services. Server and Tools revenue for the six months ended December 31, 2011 included a favorable foreign currency impact of $170 million.

Server and Tools operating income increased due to revenue growth, offset in part by higher costs of providing products and services.

Online Services Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Revenue	**$ 784**	$ 713	10%	**$ 1,425**	$ 1,260	13%
Operating loss	**$ (458)**	$ (559)	18%	**$ (971)**	$ (1,132)	14%

Online Services Division ("OSD") develops and markets information and content designed to help people simplify tasks and make more informed decisions online, and that help advertisers connect with audiences. OSD offerings include Bing, MSN, adCenter, and advertiser tools. Bing and MSN generate revenue through the sale of search and display advertising. Search and display advertising accounts for nearly all of OSD's annual revenue.

Three months ended December 31, 2011 compared with three months ended December 31, 2010

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew $81 million or 13% to $713 million, reflecting continued growth in search and display advertising revenue, offset in part by decreased third party display advertising revenue. As of December 31, 2011, according to third-party sources, Bing organic U.S. market share grew over 25% from December 31, 2010 to approximately 15%. Bing-powered U.S. market share, including Yahoo! properties, grew over 9% during this same period to approximately 27%.

OSD operating loss decreased due primarily to higher revenue and lower sales and marketing expenses, offset in part by increased cost of revenue.

Six months ended December 31, 2011 compared with six months ended December 31, 2010

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew $181 million or 16% to $1.3 billion, reflecting continued growth in search and display advertising revenue, offset in part by decreased third party display advertising revenue. As of December 31, 2011, according to third-party sources, Bing organic U.S. market share grew over 25% from December 31, 2010 to approximately 15%. Bing-powered U.S. market share, including Yahoo! properties, grew over 9% during this same period to approximately 27%.

OSD operating loss decreased due primarily to higher revenue and lower sales and marketing expenses, offset in part by increased cost of revenue.

Microsoft Business Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Revenue	**$ 6,279**	$ 6,110	3%	**$ 11,886**	$ 11,312	5%
Operating income	**$ 4,152**	$ 4,087	2%	**$ 7,839**	$ 7,570	4%

Microsoft Business Division ("MBD") develops and markets software and online services designed to increase personal, team, and organization productivity. MBD offerings include the Microsoft Office system (comprising mainly Office, SharePoint, Exchange, Lync, and Office 365), which generates over 90% of MBD revenue, and Microsoft Dynamics business solutions. We evaluate MBD results based upon the nature of the end user in two primary parts: business revenue, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue; and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

Three months ended December 31, 2011 compared with three months ended December 31, 2010

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system. Business revenue increased $420 million or 9%, primarily reflecting growth in multi-year volume licensing revenue, licensing of the 2010 Microsoft Office system to transactional business customers, and an 11% increase in Microsoft Dynamics revenue. Consumer revenue decreased $251 million or 17% due mainly to the recognition of $224 million of revenue in the prior year associated with the Office Deferral. Excluding the impact associated with the Office Deferral, consumer revenue decreased $27 million or 2% due to decreased sales of the 2010 Microsoft Office system.

MBD revenue for the three months ended December 31, 2011 included a favorable foreign currency impact of $131 million.

MBD operating income increased due to revenue growth, offset in part by higher operating expenses. Cost of revenue increased, primarily driven by higher online operation and support costs.

Six months ended December 31, 2011 compared with six months ended December 31, 2010

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system. Business revenue increased $742 million or 8%, primarily reflecting growth in multi-year volume licensing revenue, licensing of the 2010 Microsoft Office system to transactional business customers, and a 14% increase in Microsoft Dynamics revenue. Consumer revenue decreased $168 million or 7% due to the recognition of $254 million of revenue in the prior year associated with the Office Deferral. Excluding the impact associated with the Office Deferral, consumer revenue increased $86 million or 4% driven by increased sales of the 2010 Microsoft Office system.

MBD revenue for the six months ended December 31, 2011 included a favorable foreign currency impact of $337 million.

MBD operating income increased due to revenue growth, offset in part by higher operating expenses. Cost of revenue increased, primarily driven by higher online operation and support costs.

Entertainment and Devices Division

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Revenue	**$ 4,237**	$ 3,698	15%	**$ 6,198**	$ 5,493	13%
Operating income	**$ 528**	$ 666	(21)%	**$ 877**	$ 1,050	(16)%

Entertainment and Devices Division ("EDD") develops and markets products and services designed to entertain and connect people. EDD offerings include the Xbox 360 entertainment platform (which includes the Xbox 360 gaming and entertainment console, Kinect for Xbox 360, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories), Mediaroom (our Internet protocol television software), Skype, and Windows Phone, including related patent licensing revenue. In November 2010, we released Kinect for Xbox 360. We acquired Skype on October 13, 2011.

Three months ended December 31, 2011 compared with three months ended December 31, 2010

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue as well as Skype revenue from the date of acquisition. Xbox 360 platform revenue grew $322 million or 9%, led by increased volumes of Xbox 360 consoles sold and higher Xbox LIVE revenue, offset in part by lower volumes of standalone Kinect sensors sold. We shipped 8.2 million Xbox 360 consoles during the second quarter of fiscal year 2012, compared with 6.3 million Xbox 360 consoles during the second quarter of fiscal year 2011.

EDD operating income decreased reflecting higher operating expenses, offset in part by revenue growth. Cost of revenue grew $461 million or 19% primarily due to higher volumes of Xbox 360 consoles sold, payments made to Nokia related to joint strategic initiatives, Skype cost of revenue, and higher royalty costs resulting from an increase in Xbox LIVE digital marketplace third-party content sold. Research and development expenses increased $101 million or 37%, primarily reflecting higher headcount-related expenses, including Skype headcount. Sales and marketing expenses increased $94 million or 27%, primarily reflecting higher headcount-related expenses, including Skype headcount, and amortization of acquired Skype intangibles.

Six months ended December 31, 2011 compared with six months ended December 31, 2010

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue as well as Skype revenue from the date of acquisition. Xbox 360 platform revenue grew $430 million or 8%, led by increased volumes of Xbox 360 consoles sold and higher Xbox LIVE revenue, offset in part by lower volumes of standalone Kinect sensors sold and decreased video game revenue. We shipped 10.5 million Xbox 360 consoles during the first half of fiscal year 2012, compared with 9.2 million Xbox 360 consoles during the first half of fiscal year 2011. Video game revenue decreased due to strong sales of Halo Reach in the prior year.

EDD operating income decreased reflecting higher operating expenses, offset in part by revenue growth. Cost of revenue grew $633 million or 19% primarily due to higher royalty costs resulting from an increase in Xbox LIVE digital marketplace third-party content sold and sales of Gears of War 3 and due to payments made to Nokia related to joint strategic initiatives. Research and development expenses increased $125 million or 22%, primarily reflecting higher headcount-related expenses, including Skype headcount. Sales and marketing expenses increased $100 million or 19%, primarily reflecting higher headcount-related expenses, including Skype headcount, and amortization of acquired Skype intangibles.

Corporate-Level Activity

(In millions, except percentages)	Three Months Ended December 31, 2011	2010	Percentage Change	Six Months Ended December 31, 2011	2010	Percentage Change
Corporate-level activity	**$ (1,074)**	$ (954)	(13)%	**$ (2,242)**	$ (1,957)	(15)%

Certain corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; and legal settlements and contingencies.

Corporate-level expenses increased due mainly to Puerto Rican excise taxes, higher headcount-related expenses, and increased legal costs.

OPERATING EXPENSES

Cost of Revenue

(In millions, except percentages)	Three Months Ended December 31, 2011	2010	Percentage Change	Six Months Ended December 31, 2011	2010	Percentage Change
Cost of revenue	**$ 5,638**	$ 4,833	17%	**$ 9,415**	$ 7,972	18%
As a percent of revenue	**27%**	24%	3ppt	**25%**	22%	3ppt

Cost of revenue includes: manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our Web sites and to acquire online advertising space (“traffic acquisition costs”); costs incurred to support and maintain Internet-based products and services including royalties; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs.

Cost of revenue increased reflecting higher headcount-related costs, increased traffic acquisition costs, including payments made to Nokia related to joint strategic initiatives, higher Xbox 360 entertainment platform royalty costs, and higher volumes of Xbox 360 consoles sold. Headcount-related expenses increased 19% and 22% for the three and six months ended December 31, 2011, respectively, primarily related to increased Enterprise Services headcount.

Research and Development

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Research and development	**$ 2,371**	$ 2,185	9%	**$ 4,700**	$ 4,381	7%
As a percent of revenue	**11%**	11%	0ppt	**12%**	12%	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.

Research and development expenses increased, primarily reflecting a 9% increase in headcount-related expenses during the three and six months ended December 31, 2011.

Sales and Marketing

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
Sales and marketing	**$ 3,762**	$ 3,825	(2)%	**$ 6,662**	$ 6,631	1%
As a percent of revenue	**18%**	19%	(1)ppt	**17%**	18%	(1)ppt

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.

For the three months ended December 31, 2011, sales and marketing expenses decreased primarily due to decreased marketing spend. For the six months ended December 31, 2011, sales and marketing expenses increased primarily reflecting a 7% increase in headcount-related expenses, offset in part by decreased marketing spend.

General and Administrative

(In millions, except percentages)	Three Months Ended December 31,		Percentage Change	Six Months Ended December 31,		Percentage Change
	2011	**2010**		**2011**	**2010**	
General and administrative	**$ 1,120**	$ 945	19%	**$ 2,283**	$ 1,883	21%
As a percent of revenue	**5%**	5%	0ppt	**6%**	5%	1ppt

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.

General and administrative expenses increased primarily due to Puerto Rican excise taxes, higher headcount-related expenses, and increased legal costs. Headcount-related expenses increased 15% and 12% for the three and six months ended December 31, 2011, respectively.

OTHER INCOME AND INCOME TAXES

Other Income

The components of other income were as follows:

(In millions)	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Dividends and interest income	**$ 182**	$ 205	**$ 393**	$ 415
Interest expense	**(95)**	(72)	**(189)**	(117)
Net recognized gains on investments	**315**	118	**318**	152
Net gains (losses) on derivatives	**(203)**	108	**(176)**	103
Net losses on foreign currency remeasurements	**(4)**	(27)	**(44)**	(69)
Other	**50**	0	**46**	(38)
Total	**$ 245**	$ 332	**$ 348**	$ 446

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. Gains and losses from changes in fair values of derivatives that are not designated as hedges are recognized in other income (expense). These are generally offset by unrealized gains and losses in the underlying securities in the investment portfolio and are recorded as a component of other comprehensive income.

Dividends and interest income decreased slightly due to lower yields on our fixed-income investments, offset in part by higher average portfolio investment balances. Interest expense increased due to our increased issuance of debt. Net recognized gains on investments increased due primarily to higher gains on sales of equity securities, offset in part due to higher other-than-temporary impairments. Other-than-temporary impairments were $107 million and $152 million during the three and six months ended December 31, 2011, respectively, compared to $18 million and $27 million during the three and six months ended December 31, 2010. Net losses on derivatives increased for the three months ended December 31, 2011 due primarily to higher losses on currency contracts used to hedge foreign currency revenue, higher losses on equity derivatives, and lower gains on commodity derivatives. Net losses on derivatives also increased for the six months ended December 31, 2011 due primarily to losses on commodity and equity derivatives in the current period as compared to gains in the comparable period. Changes in foreign currency remeasurements were primarily due to currency movements net of our hedging activities.

Income Taxes

Our effective tax rates were approximately 20% and 22% for the three months ended December 31, 2011 and 2010, respectively, and 20% and 23% for the six months ended December 31, 2011 and 2010, respectively. Our effective tax rate was lower than the U.S. federal statutory rate and our prior year effective rates primarily due to a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico, which are subject to lower income tax rates.

Changes in the mix of income before income taxes between the U.S. and foreign countries resulted primarily from changes in the geographic distribution of and changes in consumer demand for our products and services. As discussed above, Windows Division operating income declined $401 million for the six months ended December 31, 2011, while MBD and Server and Tools operating income increased $269 million and $345 million, respectively, during this same period. We supply Windows, our primary Windows Division product, to customers through our U.S. regional operating center, while we supply the Microsoft Office System, our primary MBD product, and our Server and Tools products to customers through our foreign regional operations centers.

Tax contingencies and other tax liabilities were $7.7 billion and $7.4 billion as of December 31, 2011 and June 30, 2011, respectively, and are included in other long-term liabilities. While we settled a portion of the I.R.S. audit for tax years 2004 to 2006 during the third quarter of fiscal year 2011, we remain under audit for these years. During the fourth quarter of fiscal year 2011, the I.R.S. completed its examination and issued a Revenue Agent’s Report (“RAR”) for the remaining unresolved items. We do not agree with the adjustments in the RAR, and we have filed a protest to initiate the administrative appeals process. The proposed adjustments are primarily related to transfer pricing and could have a significant impact on our financial statements if not resolved favorably; however, we believe our existing reserves are adequate. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the appeals process will be concluded within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2011.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $51.7 billion as of December 31, 2011, compared with $52.8 billion as of June 30, 2011. Equity and other investments were $7.6 billion as of December 31, 2011 compared to $10.9 billion as of June 30, 2011. Our short-term investments are primarily to facilitate liquidity and for 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 in order 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. While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of December 31, 2011 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of our mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

We routinely monitor our financial exposure to both sovereign and non-sovereign borrowers and counterparties. Our gross exposures to our customers and investments in Portugal, Italy, Ireland, Greece, and Spain are individually and collectively not material.

Of the cash, cash equivalents, and short-term investments at December 31, 2011, approximately $46 billion was held by our foreign subsidiaries and were subject to material repatriation tax effects. The amount of cash and investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was approximately $410 million. As of December 31, 2011, approximately 65% of the short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 16% were invested in corporate notes and bonds of U.S. companies, and 4% were invested in U.S. mortgage-backed securities, all of which are denominated in U.S. dollars.

Securities lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. 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. Our securities lending payable balance was $849 million as of December 31, 2011. Our average and maximum securities lending payable balances for the three months ended December 31, 2011 were $1.3 billion and $1.4 billion, respectively. Our average and maximum securities lending payable balances for the six months ended December 31, 2011 were $1.2 billion and $1.4 billion, respectively. Intra-quarter variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

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 exchange-traded mutual funds, domestic and international equities, and U.S. treasuries. 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-backed securities, and agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured 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 labeled as Level 2 investments because the broker prices these investments based on similar assets without applying significant adjustments. In addition, all of 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

Cash flows from operations increased $2.0 billion to $14.4 billion for the six months ended December 31, 2011 due mainly to increased revenue and cash collections. Cash used in financing decreased $2.0 billion to $5.4 billion due mainly to a $6.5 billion decrease in cash used for common stock repurchases, offset in part by a $3.7 billion net decrease in proceeds from issuances of debt. Cash used in investing increased $1.4 billion to $7.9 billion due mainly to a $9.4 billion increase in acquisitions of businesses and purchases of intangible assets and a $1.5 billion decrease in cash from securities lending activities, partially offset by a $9.5 billion increase in cash provided by net purchases, maturities, and sales of investments.

Debt

We issued debt in prior periods 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 used to partially fund discretionary business acquisitions and share repurchases.

As of December 31, 2011, the total carrying value and estimated fair value of our long-term debt, including convertible debt, were $11.9 billion and $13.1 billion, respectively. This is compared to a carrying value and estimated fair value of $11.9 billion and $12.1 billion, respectively, as of June 30, 2011. The estimated fair value is based on quoted prices for our publicly-traded debt as of December 31, 2011 and June 30, 2011, as applicable.

The components of long-term debt, the associated interest rates, and the semi-annual interest record and payment dates were as follows as of December 31, 2011:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate	Interest Record Date	Interest Pay Date	Interest Record Date	Interest Pay Date
	(In millions)						
Notes							
September 27, 2013	$ 1,000	0.875%	1.000%	March 15	March 27	September 15	September 27
June 1, 2014	2,000	2.950%	3.049%	May 15	June 1	November 15	December 1
September 25, 2015	1,750	1.625%	1.795%	March 15	March 25	September 15	September 25
February 8, 2016	750	2.500%	2.642%	February 1	February 8	August 1	August 8
June 1, 2019	1,000	4.200%	4.379%	May 15	June 1	November 15	December 1
October 1, 2020	1,000	3.000%	3.137%	March 15	April 1	September 15	October 1
February 8, 2021	500	4.000%	4.082%	February 1	February 8	August 1	August 8
June 1, 2039	750	5.200%	5.240%	May 15	June 1	November 15	December 1
October 1, 2040	1,000	4.500%	4.567%	March 15	April 1	September 15	October 1
February 8, 2041	1,000	5.300%	5.361%	February 1	February 8	August 1	August 8
Total	10,750						
Convertible Debt							
June 15, 2013	1,250	0.000%	1.849%				
Total unamortized discount	(68)						
Total	$ 11,932						

Notes

The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued $1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were $1.24 billion, net of fees and expenses, which were capitalized. Each $1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of $33.40 per share. As of December 31, 2011, the net carrying amount of our convertible debt was $1.2 billion and the unamortized discount was $28 million.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft's common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of $1.24 billion were allocated between debt for $1.18 billion and stockholders' equity for $58 million with the portion in stockholders' equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with a cap price equal to $37.16. The purchased capped calls were valued at $40 million and recorded to stockholders' equity.

Unearned Revenue

Unearned revenue at December 31, 2011 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each billing coverage period and accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at December 31, 2011 also included payments for: post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions and prepaid points; Microsoft Dynamics business solutions products; Skype prepaid credit and subscriptions; OEM minimum commitments; unspecified upgrades/enhancements of Windows Phone and of Microsoft Internet Explorer on a when-and-if-available basis for Windows XP; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of December 31, 2011:

(In millions)

Three Months Ending,	
March 31, 2012	$ 6,236
June 30, 2012	4,380
September 30, 2012	2,229
December 31, 2012	1,140
Thereafter	1,349
Total	$ 15,334

Share Repurchases

During the three and six months ended December 31, 2011, we repurchased approximately 39 million and 78 million shares of Microsoft common stock for $1.0 billion and $2.0 billion, respectively, under the repurchase plan we announced on September 22, 2008. All repurchases were made using cash resources. As of December 31, 2011, approximately $10.2 billion remained of the $40.0 billion approved repurchase amount. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Dividend Per Share	Record Date	Total Amount	Payment Date
			(in millions)	
Fiscal Year 2012				
September 20, 2011	**$ 0.20**	**November 17, 2011**	**$ 1,683**	**December 8, 2011**
December 14, 2011	**$ 0.20**	**February 16, 2012**	**$ 1,676**	**March 8, 2012**
Fiscal Year 2011				
September 21, 2010	$ 0.16	November 18, 2010	$ 1,363	December 9, 2010
December 15, 2010	$ 0.16	February 17, 2011	$ 1,349	March 10, 2011

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. In evaluating estimated losses on these indemnifications, 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. To date, we have not encountered significant costs as a result of these obligations and have not accrued in our financial statements any liabilities related to these indemnifications.

Other Planned Uses of Capital

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices 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

We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. As a result, as discussed above under Cash, Cash Equivalents, and Investments, the majority of our cash, cash equivalents, and short-term investments are held by foreign subsidiaries. We currently do not intend nor foresee a need to repatriate these funds. We expect existing domestic cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our domestic operating activities and cash commitments for investing and financing activities, such as regular quarterly dividends, debt repayment schedules, and material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future. In addition, we expect existing foreign cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our foreign operating activities and cash commitments for investing activities, such as material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future.

Should we require more capital in the U.S. than is generated by our operations domestically, for example to fund significant discretionary activities, such as business acquisitions and share repurchases, we could elect to repatriate future earnings from foreign jurisdictions or raise capital in the U.S. through debt or equity issuances. These alternatives could result in higher effective tax rates, increased interest expense, or other dilution of our earnings. We have borrowed funds domestically and continue to have the ability to do so at reasonable interest rates.

RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

On July 1, 2011, we adopted guidance issued by the Financial Accounting Standards Board ("FASB") on disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll-forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). Adoption of this new guidance did not have a material impact on our financial statements.

Recent Accounting Guidance Not Yet Adopted

In December 2011, the FASB issued guidance enhancing disclosure requirements about the nature of an entity's right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. The new guidance will be effective for us beginning July 1, 2013. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

In September 2011, the FASB issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. The new guidance will be effective for us beginning July 1, 2012.

In June 2011, the FASB issued guidance on presentation of comprehensive income. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. Instead, an entity will be required to present either a continuous statement of net income and other comprehensive income or in two separate but consecutive statements. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. In December 2011, the FASB issued guidance which indefinitely defers the guidance related to the presentation of reclassification adjustments. The new guidance will be effective for us beginning July 1, 2012 and will have financial statement presentation changes only.

In May 2011, the FASB issued guidance to amend the accounting and disclosure requirements on fair value measurements. The new guidance limits the highest-and-best-use measure to nonfinancial assets, permits certain financial assets and liabilities with offsetting positions in market or counterparty credit risks to be measured at a net basis, and provides guidance on the applicability of premiums and discounts. Additionally, the new guidance expands the disclosures on Level 3 inputs by requiring quantitative disclosure of the unobservable inputs and assumptions, as well as description of the valuation processes and the sensitivity of the fair value to changes in unobservable inputs. The new guidance will be effective for us beginning January 1, 2012. Other than requiring additional disclosures, we do not anticipate material impacts on our financial statements upon adoption.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing 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 stock-based compensation.

Revenue Recognition

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence ("VSOE") of fair value exists for those elements. A portion of revenue may be recorded as unearned due to undelivered elements. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, and the fair value of the respective elements could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

Impairment of Investment Securities

Investments are reviewed 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) 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 using 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. Among our reporting units, the fair value of OSD has been the closest to its carrying value and is most sensitive to changes in assumptions. As of the date of our most recent goodwill impairment test, May 1, 2011, OSD’s fair value exceeded its carrying value by 21%. The carrying value of OSD’s goodwill was $6.4 billion as of December 31, 2011.

The estimates used to calculate the fair value of a reporting unit change from year to year based on operating results and market conditions. 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 manufacturing. 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. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. 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 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 should be 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 current and 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 financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial statements.

Stock-Based Compensation

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be impacted.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign currency exchange rates, interest rates, credit risk, equity prices, and commodity prices. A portion of these risks is hedged, but they may impact our financial statements.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily and use hedges where practicable to offset the risks and maximize the economic effectiveness of our foreign currency positions. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar.

Interest Rate

Our fixed-income portfolio is diversified across credit sectors and maturities, consisting primarily of investment-grade securities. The credit risk and average maturity of the fixed-income portfolio is managed to achieve economic returns that correlate to certain global and domestic fixed-income indices. In addition, we use "To Be Announced" forward purchase commitments of mortgage-backed assets to gain exposure to agency and mortgage-backed securities.

Equity

Our equity portfolio consists of global, developed, and emerging market securities that are subject to market price risk. We manage the securities relative to certain global and domestic indices and expect their economic risk and return to correlate with these indices.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and facilitate portfolio diversification. Our investment portfolio has exposure to a variety of commodities, including precious metals, energy, and grain. We manage these exposures relative to global commodity indices and expect their economic risk and return to correlate with these indices.

VALUE-AT-RISK

We use a value-at-risk ("VaR") model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in the fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model 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 ("U.S. GAAP"), but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

The VaR is calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, and legal risk.

The following table sets forth the one-day VaR for substantially all of our positions as of December 31, 2011 and June 30, 2011 and for the three months ended December 31, 2011:

(In millions)

	December 31, 2011	June 30, 2011	Three Months Ended December 31, 2011		
Risk Categories			**Average**	**High**	**Low**
Foreign currency	**$ 159**	$ 86	**$ 181**	**$ 215**	**$ 131**
Interest rate	**$ 59**	$ 58	**$ 63**	**$ 66**	**$ 58**
Equity	**$ 157**	$ 212	**$ 170**	**$ 193**	**$ 150**
Commodity	**$ 17**	$ 28	**$ 20**	**$ 23**	**$ 16**

Total one-day VaR for the combined risk categories was $298 million at December 31, 2011 and $290 million at June 30, 2011. The total VaR is 24% less at December 31, 2011, and 25% less at June 30, 2011, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

ITEM 4. 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. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 15 – Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding certain legal proceedings in which we are involved.

ITEM 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock.

The cloud-based computing model presents execution and competitive risks. We are transitioning our strategy to a computing environment characterized by cloud-based services used with smart client devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud. We are devoting significant resources to develop and deploy our own competing cloud-based software plus services strategies. While we believe our expertise, investments in infrastructure, and the breadth of our cloud-based services provides us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

- continuing to innovate and bring to market compelling cloud-based experiences that generate increasing traffic and market share;
- maintaining the utility, compatibility, and performance of our cloud-based services on the growing array of computing devices, including PCs, smartphones, handheld computers, netbooks, tablets, and television-related devices;
- continuing to enhance the attractiveness of our cloud platforms to third-party developers; and
- ensuring that our cloud services meet the reliability expectations of our customers and maintain the security of their data.

Challenges to our business models may reduce our revenue or operating margins. Whether our software runs in the cloud or on a device, we continue to face challenges from alternative means of developing and licensing software. Under our license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. Certain "open source" software business models challenge our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. Some companies compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not bear the full costs of research and development for the software. In some cases, their products may infringe our patents. In addition, advertising-based business models seek revenue by delivering third party advertisements to end customers who receive the software and services at no direct costs. Gains in market acceptance of open source or advertising based software may adversely affect our sales, revenue, and operating margins.

An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A competing vertically-integrated model, in which a single firm controls both the software and hardware elements of a product, has been successful with certain consumer products such as personal computers, mobile phones, and digital music players. We also offer vertically-integrated hardware and software products; however, efforts to compete with the vertically integrated model may increase our cost of sales and reduce our operating margins.

We derive substantial revenue from licenses of Windows operating systems on personal computers. The proliferation of alternative devices and form factors creates challenges from competing software platforms. It is uncertain to what extent alternative devices will increase the number of computing devices that users own, or will substitute for users' personal computer purchases. Alternative devices also run operating systems and applications developed by our competitors. These factors could impact our revenue and operating margins.

We face intense competition. We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and portfolio of products and services is a competitive advantage, our competitors that are focused on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products, in some cases in violation of our intellectual property rights or on the basis of technical specifications for Microsoft technologies that we make available at little or no cost in connection with our interoperability initiatives. In response to competition, we continue to develop versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins, and operating income.

We may not be able to adequately protect our intellectual property rights. Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult. While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. As a result, our revenue in these markets may grow slower than the underlying PC market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

Third parties may claim we infringe their intellectual property rights. From time to time, we receive notices from others claiming we infringe their intellectual property rights. Because of constant technological change in the segments in which we compete, the extensive patent coverage of existing technologies, and the rapid rate of issuance of new patents, it is possible the number of these claims may grow. To resolve these claims we may enter into royalty and licensing agreements on terms that are less favorable than currently available, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code. Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. This could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code also could increase the security risks described in the next paragraph.

Security vulnerabilities could lead to reduced revenue, liability claims, or competitive harm. Maintaining the security of computers and computer networks is paramount for us and our customers. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products and services and gain access to our networks and data centers. Although this is an industry-wide problem that affects computers across all platforms, it affects our products and services in particular because hackers tend to focus their efforts on the most popular operating systems, programs, and services, and we expect them to continue to do so. Groups of hackers may also act in a coordinated manner to launch distributed denial of service attacks, or other coordinated attacks, that may cause service outages or other interruptions. We devote significant resources to address security vulnerabilities through:

- engineering more secure products and services;
- enhancing security and reliability features in our products and services, and continuously evaluating and updating those security and reliability features;
- helping our customers make the best use of our products and services to protect against computer viruses and other attacks;
- improving the deployment of software updates to address security vulnerabilities;
- investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed; and
- providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

We also devote significant resources to protect the digital security infrastructure that ensures the integrity of our products and services. The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products and services could cause significant reputational harm and lead some customers to seek to return products, to reduce or delay future purchases or adoption of services, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. Actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges.

In addition, our internal information technology environment continues to evolve. We are often early adopters of new devices and technologies. We embrace new ways of sharing data and communicating with partners and customers using methods such as social networking. These practices can enhance efficiency and business insight, but they also present risks that our business policies and internal security controls may not keep pace with the speed of these changes. If third parties gain access to our networks or data centers, they could obtain and exploit confidential business information and harm our competitive position.

Improper disclosure of personal data could result in liability and harm our reputation. As we continue to execute our strategy of increasing the number and scale of our cloud-based offerings, we store and process increasingly large amounts of personally identifiable information of our customers. At the same time, the continued occurrence of high-profile data breaches provides evidence of an external environment increasingly hostile to information security. This environment demands that we continuously improve our design and coordination of security controls across our business groups and geographies. Despite these efforts, it is possible our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information. Improper disclosure of this information could harm our reputation, lead to legal exposure to customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data on premises or, increasingly, in a cloud-based environment we host. We believe consumers using our email, messaging, storage, sharing, and social networking services will increasingly want efficient, centralized methods of choosing their privacy preferences and controlling their data. Perceptions that our products or services do not adequately protect the privacy of personal information could inhibit sales of our products or services, and could constrain consumer and business adoption of cloud-based solutions.

We may experience outages, data loss and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic and complexity of our products and services demand more computing power. We have spent and expect to continue to spend substantial amounts to purchase or lease data centers and equipment and to upgrade our technology and network infrastructure to handle increased traffic on our Web sites and in our data centers, and to introduce new products and services and support existing services such as Bing, Exchange Online, Office 365, SharePoint Online, Xbox LIVE, Windows Azure, Windows Live, and Microsoft Office Web Apps. We also are growing our business of providing a platform and back-end hosting for services provided by third-party businesses to their end customers. Maintaining and expanding this infrastructure is expensive and complex. Inefficiencies or operational failures, including temporary or permanent loss of customer data, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

We are subject to government litigation and regulatory activity that affects how we design and market our products. As a leading global software maker, we receive close scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers to assert claims of anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints included limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. Although the Consent Decree and Final Judgment expired in May 2011, we expect that federal and state antitrust authorities will continue to closely scrutinize our business.

The European Commission closely scrutinizes the design of high-volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. In 2004, the Commission ordered us to create new versions of Windows that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. In 2009, the Commission accepted a set of commitments offered by Microsoft to address the Commission's concerns relating to competition in Web browsing software. The Commission's impact on product design may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our own products which could result in decreased sales of our products.

Government regulatory actions and court decisions such as these may hinder our ability to provide the benefits of our software to consumers and businesses, thereby reducing the attractiveness of our products and the revenue that come from them. New actions could be initiated at any time, either by these or other governments or private claimants, including with respect to new versions of Windows or other Microsoft products. The outcome of such actions, or steps taken to avoid them, could adversely affect us in a variety of ways, including:

- We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail a delay in a product release and removing functionality that customers want or on which developers rely.
- We may be required to make available licenses to our proprietary technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.
- The rulings described above may be used as precedent in other competition law proceedings.

Our products and online services offerings, including new technologies we develop or acquire such as Skype, are subject to government regulation in some jurisdictions, including in areas of user privacy, telecommunications, data protection, and online content. The application of these laws and regulations to our business is often unclear, subject to change over time, and sometimes may conflict from jurisdiction to jurisdiction. Additionally these laws and governments' approach to their enforcement, as well as our products and services, are continuing to evolve. Compliance with these types of regulation may involve significant costs or require changes in products or business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop the alleged noncompliant activity.

Our business depends on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

Delays in product development schedules may adversely affect our revenue. The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Our increasing focus on cloud-based software plus services also presents new and complex development issues. Significant delays in new product or service releases or significant problems in creating new products or services could adversely affect our revenue.

We make significant investments in new products and services that may not be profitable. Our growth depends on our ability to innovate by offering new, and adding value to our existing, software and service offerings. We will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, Windows Live, the Windows Azure Services platform and other cloud-based services offerings, and the Xbox 360 entertainment platform. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Our degree of success with Windows Phone, for example, will impact our ability to grow our share of the smartphone operating system market. It will also be an important factor in supporting our strategy of delivering value to end users seamlessly over PC, phone, and TV device classes. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

Adverse economic conditions may harm our business. Unfavorable changes in economic conditions, including inflation, recession, or other changes in economic conditions, may result in lower information technology spending and adversely affect our revenue. If demand for PCs, servers, and other computing devices declines, or consumer or business spending for those products declines, our revenue will be adversely affected. Our product distribution system also relies on an extensive partner network. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, could result in sales channel disruption. Challenging economic conditions also may impair the ability of our customers to pay for products and services they have purchased. As a result, reserves for doubtful accounts and write-offs of accounts receivable may increase. We maintain an investment portfolio of various holdings, types, and maturities.

These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that have affected global financial markets. A significant part of our investment portfolio consists of U.S. government securities. If global credit and equity markets experience prolonged periods of decline, or if there is a downgrade of U.S. government debt, our investment portfolio may be adversely impacted and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely impact our financial results.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. Although management currently believes resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial statements, the litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. A material adverse impact on our financial statements also could occur for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions may result in higher effective tax rates for the company. In addition, there have been proposals to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form this proposed legislation may pass, if enacted it could have a material adverse impact on our tax expense and cash flow.

Our vertically-integrated hardware and software products may experience quality or supply problems. Our hardware products such as the Xbox 360 console are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We obtain some components of our hardware devices from sole suppliers. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Either component shortages or excess or obsolete inventory may increase our cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenue and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. Under accounting principles generally accepted in the United States ("U.S. GAAP"), we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is tested for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the U.S. and other countries. Operations outside the U.S. may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments by our employees, vendors, or agents. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region, such as current uncertainties relating to European sovereign and other debt, and difficulties in staffing and managing foreign operations, may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenue.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations. Our move toward providing our customers with more services and solutions in the cloud puts a premium on the resilience of our systems and strength of our business continuity management plans, and magnifies the potential impact of prolonged outages on our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may result in supply chain disruptions for hardware manufacturers, either of which may adversely affect our revenue. The long-term effects of climate change on the global economy in general or the information technology industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services. New regulations may require us to find alternative compliant and cost-effective methods of distributing our products and services.

Acquisitions, joint ventures and strategic alliances may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures and strategic alliances as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don’t realize a satisfactory return on our investment, or that we experience difficulty integrating new employees, business systems, and technology, or diversion of management’s attention from our other businesses. Our recent acquisition of Skype, for example, provides opportunities to enhance our existing products. The success of our integration of Skype will depend in part on our ability to create innovative and compelling experiences that distinguish us from our competitors in both consumer and business markets. It may take longer than expected to realize the full benefits from these transactions, such as increased revenue, enhanced efficiencies, or market share, or those benefits may ultimately be smaller than anticipated, or may not be realized. These events could harm our operating results or financial condition.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Items 2(a) and (b) are not applicable.

(c) STOCK REPURCHASES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Programs
				(in millions)
October 1, 2011 – October 31, 2011	0	$ 0	0	$ 11,221
November 1, 2011 – November 30, 2011	16,262,981	$ 25.19	16,262,981	$ 10,811
December 1, 2011 – December 31, 2011	23,116,971	$ 25.53	23,116,971	$ 10,221
	39,379,952		39,379,952	

During the second quarter of fiscal year 2012, we repurchased 39.4 million shares of Microsoft common stock for $1.0 billion using cash resources. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of December 31, 2011, approximately $10.2 billion remained of our $40.0 billion repurchase program that we announced on September 22, 2008. The program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

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15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

* *Indicates a management contract or compensatory plan or arrangement*

** *Furnished, not filed.*

Items 3 and 5 are not applicable and have been omitted.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MICROSOFT CORPORATION

/s/ FRANK H. BROD

Frank H. Brod
Corporate Vice President, Finance and Administration;
Chief Accounting Officer (Duly Authorized Officer)

January 19, 2012

Exhibit 10.1

MICROSOFT CORPORATION

2001 STOCK PLAN
(as amended and restated effective as of December 13, 2011)

1. Purpose of the Plan. The purposes of this Stock Plan are to attract and retain the best available individuals for positions of substantial responsibility, to provide additional incentive to such individuals, and to promote the success of the Company's business by aligning the financial interests of Employees and Consultants providing personal services to the Company or to any Parent or Subsidiary of the Company with long-term shareholder value.

Awards granted hereunder may be Incentive Stock Options, Nonqualified Stock Options, Stock Awards, or SARs, at the discretion of the Board and as reflected in the terms of the Award Agreement.

2. Definitions. As used herein, the following definitions shall apply:

(a) "Award" shall mean any award or benefits granted under the Plan, including Options, Stock Awards, and SARs.

(b) "Award Agreement" shall mean a written or electronic agreement between the Company and the Awardee setting forth the terms of the Award.

(c) "Awardee" shall mean the holder of an outstanding Award.

(d) "Board" shall mean (i) the Board of Directors of the Company or (ii) both the Board and the Committee, if a Committee has been appointed in accordance with Section 4(a) of the Plan.

(e) "Code" shall mean the Internal Revenue Code of 1986, as amended.

(f) "Committee" shall mean the Compensation Committee appointed by the Board of Directors in accordance with Section 4(a) of the Plan, if one is appointed; provided, however, if the Board of Directors appoints more than one Committee pursuant to Section 4(a), then "Committee" shall refer to the appropriate Committee, as indicated by the context of the reference.

(g) "Common Shares" shall mean the common shares of Microsoft Corporation.

(h) "Company" shall mean Microsoft Corporation, a Washington corporation and any successor thereto.

(i) "Consultant" shall mean any person, except an Employee, engaged by the Company or any Parent or Subsidiary of the Company, to render personal services to such entity, including as an advisor.

(j) "Continuous Status as a Participant" shall mean (1) for Employees, the absence of any interruption or termination of service as an Employee, and (2) for Consultants, the absence of any interruption, expiration, or termination of such person's consulting or advisory relationship with the Company or the occurrence of any termination event as set forth in such person's Award Agreement. Continuous Status as a Participant shall not be considered interrupted (i) for an Employee in the case of sick leave, maternity leave, infant care leave, medical emergency leave, military leave, or any other leave of absence for which Continuous Status is not considered interrupted in accordance with the Company's policies on such matters, and (ii) for a Consultant, in the case of any temporary interruption in such person's availability to provide services to the Company which has been authorized in writing by a Vice President of the Company prior to its commencement.

(k) “Conversion Options” shall mean the Options described in Section 6(c) of the Plan.

(l) “Employee” shall mean any person, including an officer, who is a common law employee of, receives remuneration for personal services to, is reflected on the official human resources database as an employee of, and is on the payroll of the Company or any Parent or Subsidiary of the Company. A person is on the payroll if he or she is paid from the payroll department of the Company, or any Parent or Subsidiary of the Company. Persons providing services to the Company, or to any Parent or Subsidiary of the Company, pursuant to an agreement with a staff leasing organization, temporary workers engaged through or employed by temporary or leasing agencies, and workers who hold themselves out to the Company, Parent, or Subsidiary to which they are providing services as being independent contractors, or as being employed by or engaged through another company while providing the services are not Employees for purposes of this Plan, whether or not such persons are, or may be reclassified by the courts, the Internal Revenue Service, the U. S. Department of Labor, or other person or entity as, common law employees of the Company, Parent, or Subsidiary, either solely or jointly with another person or entity.

(m) “Effective Date” shall mean January 1, 2001.

(n) “Exchange Act” shall mean the Securities Exchange Act of 1934, as amended.

(o) “Incentive Stock Option” shall mean any Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code.

(p) “Maximum Annual Participant Award” shall have the meaning set forth in Section 5(b).

(q) “Nonqualified Stock Option” shall mean an Option not intended to qualify as an Incentive Stock Option.

(r) “Option” shall mean a stock option granted pursuant to Section 6 of the Plan.

(s) “Parent” shall mean a “parent corporation,” whether now or hereafter existing, as defined in Section 424(e) of the Code.

(t) “Participant” shall mean an Employee or Consultant.

(u) “Plan” shall mean this 2001 Stock Plan, including any amendments thereto.

(v) “Share” shall mean one Common Share, as adjusted in accordance with Section 14 of the Plan.

(w) “SAR” shall mean a stock appreciation right awarded pursuant to Section 8 of the Plan.

(x) “Stock Award” shall mean a grant of Shares or of a right to receive Shares or their cash equivalent (or both) pursuant to Section 7 of the Plan.

(y) “Subsidiary” shall mean (i) in the case of an Incentive Stock Option a “subsidiary corporation,” whether now or hereafter existing, as defined in Section 424(f) of the Code, and (ii) in the case of a Nonqualified Stock Option, a Stock Award or an SAR, with the approval of the Board, Committee or other person authorized to administer the Plan in accordance with Section 4 of the Plan, a limited liability company, partnership or other entity in which the Company controls 50 percent or more of the voting power or equity interests.

3. Shares Subject to the Plan. Subject to the provisions of Sections 14 and 16 of the Plan, the maximum aggregate number of Shares (increased, proportionately, in the event of any stock split, stock dividend or similar event with respect to the Shares) which may be awarded and delivered under the Plan shall not exceed the sum of (a) any Shares available for future awards, as of the Effective Date, under the Microsoft Corporation 1991 Stock Option Plan, as amended ("1991 Stock Plan") and (b) any Shares that are represented by awards under the 1991 Stock Plan which, after the Effective Date, are forfeited, expire, are cancelled without delivery of Shares, or otherwise result in the return of Shares to the Company, minus (c) 100,000,000 Shares (unadjusted for any stock split or stock dividend with respect to the Shares). The Shares may be authorized, but unissued, or reacquired Common Shares.

Subject to the provisions of the following sentence, if an Award should expire or become unexercisable for any reason without having been exercised in full, the undelivered Shares which were subject thereto shall, unless the Plan shall have been terminated, become available for future Awards under the Plan. Notwithstanding anything to the contrary contained herein, any Awards of Options that are transferred to a third party pursuant to a program under which the holder of certain Options may transfer such Options to such third party in exchange for cash or other consideration, shall be removed from the Plan and the Shares subject to such Awards shall not be available for regrant under the Plan regardless of whether the transferred Options are exercised or expire without exercise.

4. Administration of the Plan.

(a) Procedure. The Plan shall be administered by the Board of Directors of the Company.

(i) The Board of Directors may appoint one or more Committees each consisting of not less than two members of the Board of Directors to administer the Plan on behalf of the Board of Directors, subject to such terms and conditions as the Board of Directors may prescribe. Once appointed, such Committees shall continue to serve until otherwise directed by the Board of Directors.

(ii) From time to time the Board of Directors may increase the size of the Committee(s) and appoint additional members thereof, remove members (with or without cause) and appoint new members in substitution therefor, or fill vacancies however caused.

(iii) The Committee(s) appointed to administer the Plan on behalf of the Board of Directors may delegate its authority to administer the Plan to the extent provided in the charter for the Committee(s) or a resolution of the Board.

(b) Powers of the Board. Subject to the provisions of the Plan, the Board shall have the authority, in its discretion: (i) to grant Incentive Stock Options, Nonqualified Stock Options, Stock Awards, and SARs; (ii) to determine, in accordance with Section 11(b) of the Plan, the fair market value of the Shares; (iii) to determine, in accordance with Section 11(a) of the Plan, the exercise price per share of Awards to be granted; (iv) to determine the Participants to whom, and the time or times at which, Awards shall be granted and the number of Shares to be represented by each Award; (v) to interpret the Plan and the terms of Awards; (vi) to prescribe, amend, and rescind rules and regulations relating to the Plan; including the form of Award Agreement, and manner of acceptance of an Award, (vii) to determine the terms and provisions of each Award to be granted (which need not be identical) and, with the consent of the Awardee, modify or amend any Award; (viii) to authorize conversion or substitution under the Plan of any or all Conversion Options; (ix) to accelerate or defer (with the consent of the Awardee) the vesting or exercise date of any Award; (x) to authorize any person to execute on behalf of the Company any instrument required to effectuate the grant of an Award previously granted by the Board; and (xi) to make all other determinations deemed necessary or advisable for the administration of the Plan; *provided that,* no consent of an Awardee is necessary under clauses (vii) or (ix) if the modification, amendment, acceleration, or deferral, in the reasonable judgment of the Board confers a benefit on the Awardee, or is made pursuant to an adjustment in accordance with Section 14.

The Board may, but need not, determine that an award shall vest or be granted subject to the satisfaction of one or more performance goals. Performance goals for awards will be determined by the Compensation Committee of the Board and will be designed to support the business strategy, and align executives' interests with customer and shareholder interests. For awards that are intended to qualify as performance-based compensation under Section 162(m), performance goals will be based on one or more of the following business criteria: sales or licensing volume, revenues, customer satisfaction, expenses, organizational health/productivity, earnings (which includes similar measurements such as net profits, operating profits and net income, and which may be calculated before or after taxes, interest, depreciation, amortization or taxes), margins, cash flow, shareholder return, return on equity, return on assets or return on investments, working capital, product shipments or releases, brand or product recognition or acceptance and/or stock price. These criteria may be measured: individually, alternatively or in any combination; with respect to the Company, a subsidiary, division, business unit, product line, product or any combination of the foregoing; on an absolute basis, or relative to a target, to a designated comparison group, to results in other periods or to other external measures; and including or excluding items that could affect the measurement, such as extraordinary or unusual and nonrecurring gains or losses, litigation or claim judgments or settlements, material changes in tax laws, acquisitions or divestitures, the cumulative effect of accounting changes, asset write-downs, restructuring charges, or the results of discontinued operations.

(c) Effect of Board's Decision. All decisions, determinations, and interpretations of the Board shall be final and binding on all Participants and Awardees.

5. Eligibility.

(a) Awards may be granted to Participants and to persons to whom offers of employment as an Employee have been extended; provided that Incentive Stock Options may only be granted to Employees. For avoidance of doubt, directors are not eligible to participate in the Plan unless they are Employees or Consultants.

(b) The maximum number of Shares with respect to which an Award or Awards may be granted to any Participant in any one taxable year of the Company (the "Maximum Annual Participant Award") shall not exceed 20,000,000 Common Shares for Options or SARs, or 5,000,000 shares for Stock Awards (increased, in both cases proportionately, in the event of any stock split, stock dividend or similar event with respect to the Shares). If an Option is in tandem with an SAR, such that the exercise of the Option or SAR with respect to a Share cancels the tandem SAR or Option right, respectively, with respect to each Share, the tandem Option and SAR rights with respect to each Share shall be counted as covering but one Share for purposes of the Maximum Annual Participant Award.

6. Options.

(a) Each Option shall be designated in the written or electronic option agreement as either an Incentive Stock Option or a Nonqualified Stock Option. However, notwithstanding such designations, to the extent that the aggregate fair market value of the Shares with respect to which Options designated as Incentive Stock Options are exercisable for the first time by any Employee during any calendar year (under all plans of the Company) exceeds $100,000, such Options shall be treated as Nonqualified Stock Options.

(b) For purposes of Section 6(a), Options shall be taken into account in the order in which they were granted, and the fair market value of the Shares shall be determined as of the time the Option with respect to such Shares is granted.

(c) Options converted or substituted under the Plan for any or all outstanding stock options and stock appreciation rights held by employees, consultants, advisors or other option holders granted by entities subsequently acquired by the Company or a subsidiary or affiliate of the Company ("Conversion Options") shall be effective as of the close of the respective mergers into, or acquisitions of such entities by, the Company or a subsidiary or affiliate of the Company; provided that such Conversion Options may not be exercised during any periods that may be specified by the Company immediately following the close of the merger or acquisition necessary to ensure compliance with applicable law. The Conversion Options may be Incentive Stock Options or Nonqualified Stock Options, as determined by the Committee; provided, however, that stock appreciation rights in the acquired entity shall only be converted to or substituted with Nonqualified Stock Options. The Conversion Options shall be options to purchase the number of Common Shares determined by multiplying the number of shares of the acquired entity's common stock underlying each such stock option or stock appreciation right immediately prior to the closing of such merger or acquisition by the number specified in the applicable merger or acquisition agreement for conversion of each share of such entity's common stock to a Common Share (the "Merger Ratio"), rounded down to the closest whole share. Such Conversion Options shall be exercisable at an exercise price per Common Share (increased to the nearest whole cent) equal to the exercise price per share of the acquired entity's common stock under each such stock option or stock appreciation right immediately prior to closing divided by the Merger Ratio. No fractional Common Shares will be issued upon exercise of Conversion Options. In lieu of such issuance, the Common Shares issued pursuant to each such exercise shall be rounded to the closest whole Share. Conversion Options may be granted and exercised without the issuance of an Award Agreement.

7. Stock Awards.

(a) Stock Awards may be granted either alone, in addition to, or in tandem with other Awards granted under the Plan. After the Committee determines that it will offer a Stock Award, it will advise the Awardee in writing or electronically, by means of an Award Agreement, of the terms, conditions and restrictions, including vesting, if any, related to the offer, including the number of Shares that the Awardee shall be entitled to receive or purchase, the price to be paid, if any, and, if applicable, the time within which the Awardee must accept the offer. The offer shall be accepted by execution of an Award Agreement in the manner determined by the Committee; provided that Shares may be issued to an Awardee under a fully vested Stock Award without the issuance of an Award Agreement.

(b) Unless the Committee determines otherwise, the Award Agreement shall provide for the forfeiture of the non-vested Common Shares underlying such Stock Award upon the Awardee ceasing to be a Participant. To the extent that the Awardee purchased the Shares granted under such Stock Award and any such Shares remain non-vested at the time the Awardee ceases to be a Participant, the cessation of Participant status shall cause an immediate sale of such non-vested Shares to the Company at the original price per Common Share paid by the Awardee.

8. SARs.

(a) The Committee shall have the full power and authority, exercisable in its sole discretion, to grant SARs to selected Awardees. The Committee is authorized to grant both tandem stock appreciation rights ("Tandem SARs") and stand-alone stock appreciation rights ("Stand-Alone SARs") as described below.

(b) Tandem SARs.

(i) Awardees may be granted a Tandem SAR, exercisable upon such terms and conditions as the Committee shall establish, to elect between the exercise of the underlying Section 6 Option for Common Shares or the surrender of the Option in exchange for a distribution from the Company in an amount equal to the excess of (A) the fair market value (on the Option surrender date) of the number of Shares in which the Awardee is at the time vested under the surrendered Option (or surrendered portion thereof) over (B) the aggregate exercise price payable for such vested Shares.

(ii) No such Option surrender shall be effective unless it is approved by the Committee, either at the time of the actual Option surrender or at any earlier time. If the surrender is so approved, then the distributions to which the Awardee shall become entitled under this Section 8(b) may be made in Common Shares valued at fair market value on the Option surrender date, in cash, or partly in Shares and partly in cash, as the Committee shall deem appropriate.

(iii) If the surrender of an Option is not approved by the Committee, then the Awardee shall retain whatever rights he or she had under the surrendered Option (or surrendered portion thereof) on the Option surrender date and may exercise such rights at any time prior to the later of (A) five (5) business days after the receipt of the rejection notice or (B) the last day on which the Option is otherwise exercisable in accordance with the terms of the instrument evidencing such Option, but in no event may such rights be exercised more than ten (10) years after the date of the Option grant.

(c) Stand-Alone SARs.

(i) An Awardee may be granted a Stand-Alone SAR not tied to any underlying Option under Section 6 of the Plan. The Stand-Alone SAR shall cover a specified number of Common Shares and shall be exercisable upon such terms and conditions as the Committee shall establish. Upon exercise of the Stand-Alone SAR, the holder shall be entitled to receive a distribution from the Company in an amount equal to the excess of (A) the aggregate fair market value (on the exercise date) of the Common Shares underlying the exercised right over (B) the aggregate base price in effect for those Shares.

(ii) The number of Common Shares underlying each Stand-Alone SAR and the base price in effect for those Shares shall be determined by the Committee at the time the Stand-Alone SAR is granted. In no event, however, may the base price per Share be less than the fair market value per underlying Common Share on the grant date.

(iii) The distribution with respect to an exercised Stand-Alone SAR may be made in Common Shares valued at fair market value on the exercise date, in cash, or partly in Shares and partly in cash, as the Committee shall deem appropriate.

(d) The Common Shares underlying any SARs exercised under this Section 8 shall not be available for subsequent issuance under the Plan.

9. Term of Plan. The Plan shall become effective as of the Effective Date. It shall continue in effect until terminated under Section 17 of the Plan.

10. Term of Award; Limitations on Vesting and Repricing.

(a) The term of each Award shall be no more than ten (10) years from the date of grant. However, in the case of an Incentive Stock Option granted to a Participant who, at the time the Option is granted, owns Shares representing more than ten percent (10%) of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the term of the Option shall be no more than five (5) years from the date of grant.

(b) Each Award shall vest over a period of not less than three (3) years from the date of grant, provided that Awards covering up to 50,000,000 shares (increased, proportionately, in the event of any stock split, stock dividend or similar event) may be granted without regard to the 3-year vesting restriction; provided further, that Conversion Options and awards that are granted or vest based on performance goals or that vest in less than three (3) years based on death, disability, or retirement shall not count toward the limit of this Section 10(b).

(c) No Award may be repriced, replaced, regranted through cancellation, or modified without approval of the shareholders of the Company (except in connection with an adjustment pursuant to Section 14) if the effect would be to reduce the exercise price for the Shares underlying such Award.

11. <u>Exercise Price and Consideration</u>.

(a) The per Share exercise price under each Award shall be such price as is determined by the Board, subject to the following:

(i) In the case of an Incentive Stock Option

(A) granted to an Employee who, at the time of the grant of such Incentive Stock Option, owns shares representing more than ten percent (10%) of the voting power of all classes of shares of the Company or any Parent or Subsidiary, the per Share exercise price shall be no less than 110% of the fair market value per Share on the date of grant.

(B) granted to any other Employee, the per Share exercise price shall be no less than 100% of the fair market value per Share on the date of grant.

(ii) Except for Conversion Options under Section 6(c), the per Share exercise price under a Nonqualified Stock Option or SAR shall be no less than seventy-five percent (75%) of the fair market value per Share on the date of grant. Notwithstanding the foregoing (or any other provision of the Plan), Options and SARs that are granted to Employees who are non-exempt for purposes of the FLSA, shall satisfy the requirements for exclusion from regular rate of pay for purposes of the FLSA and shall have an exercise price that is at least eighty-five percent (85%) of the fair market value of the underlying Shares at the time of grant; furthermore, such Options or SARs shall not be exercisable within the six (6) month period immediately following the date of grant, except, if so provided in the Award Agreement, in the event of the Awardee’s death, disability, or retirement, upon a change in corporate control of the Company, or under such other circumstances as are permitted under the FLSA or rules and regulations thereunder.

(iii) The maximum aggregate number of Shares underlying all Nonqualified Stock Options and SARs with a per Share exercise price of less than fair market value on any grant date that may be granted under this Plan is 50,000,000 Shares (increased, proportionately, in the event of any stock split, or stock dividend or similar event with respect to the Shares); provided that Conversion Options shall not count against the limit of this Section 11(a)(iii).

(b) The fair market value per Share shall be the closing price per share of the Common Share on the Nasdaq Stock Market (“Nasdaq”) on the date of grant. If the Shares cease to be listed on Nasdaq, the Board shall designate an alternative method of determining the fair market value of the Shares.

(c) The consideration to be paid for the Shares to be issued upon exercise of an Award, including the method of payment, shall be determined by the Board at the time of grant and may consist of cash and/or check. Payment may also be made by delivering a properly executed exercise notice together with irrevocable instructions to a broker to promptly deliver to the Company the amount of sale proceeds necessary to pay the exercise price. If the Awardee is an officer of the Company within the meaning of Section 16 of the Exchange Act, the officer may, in addition, be allowed to pay all or part of the purchase price with Shares which, as of the exercise date, the officer has owned for six (6) months or more. If the Awardee is a participant in the 1998 Microsoft Corporation Stock Option Gain And Bonus Deferral Program, he may in addition be allowed to pay all or part of the purchase price of any deferred Option with Shares. Shares used by officers to pay the exercise price shall be valued at their fair market value on the exercise date.

(d) Prior to issuance of the Shares upon exercise of an Award, the Awardee shall pay any federal, state, and local income and employment tax withholding obligations applicable to such Award. If an Awardee is an officer of the Company within the meaning of Section 16 of the Exchange Act, he may elect to pay such withholding tax obligations by having the Company withhold Shares having a value equal to the amount required to be withheld, and any Award under the Plan may permit or require that such withholding tax obligations be paid by having the Company withhold Shares having a value equal to the amount required to be withheld. The value of the Shares to be withheld shall equal the fair market value of the Shares on the day the Award is exercised. The right of an officer to dispose of Shares to the Company in satisfaction of withholding tax obligations shall be deemed to be approved as part of the initial grant of an Award, unless thereafter rescinded, and shall otherwise be made in compliance with Rule 16b-3 and other applicable regulations, and any Award under the Plan may permit or require that such withholding tax obligations be paid by having the Company withhold Shares having a value equal to the amount required to be withheld.

12. Exercise of Award.

(a) Procedure for Exercise; Rights as a Shareholder. Any Award granted hereunder shall be exercisable at such times and under such conditions as determined by the Board at the time of grant, and as shall be permissible under the terms of the Plan.

An Award may not be exercised for a fraction of a Share.

An Award shall be deemed to be exercised when written or electronic notice of such exercise has been given to the Company in accordance with the terms of the Award by the person entitled to exercise the Award and full payment for the Shares with respect to which the Award is exercised has been received by the Company. Full payment may, as authorized by the Board, consist of any consideration and method of payment allowable under Section 11(c) of the Plan. Until the issuance (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company) of the share certificate evidencing such Shares, no right to vote or receive dividends or any other rights as a shareholder shall exist with respect to the Shares subject to the Award, notwithstanding the exercise of the Award. The Company shall issue (or cause to be issued) such share certificate promptly upon exercise of the Award. In the event that the exercise of an Award is treated in part as the exercise of an Incentive Stock Option and in part as the exercise of a Nonqualified Stock Option pursuant to Section 6(a), the Company shall issue a share certificate evidencing the Shares treated as acquired upon the exercise of an Incentive Stock Option and a separate share certificate evidencing the Shares treated as acquired upon the exercise of a Nonqualified Stock Option, and shall identify each such certificate accordingly in its share transfer records. No adjustment will be made for a dividend or other right for which the record date is prior to the date the share certificate is issued, except as provided in Section 14 of the Plan.

Exercise of an Award in any manner and delivery of the Shares subject to such Award shall result in a decrease in the number of Shares which thereafter may be available, both for purposes of the Plan and for sale under the Award, by the number of Shares as to which the Award is exercised.

(b) Termination of Status as a Participant. In the event of termination of an Awardee's Continuous Status as a Participant, such Awardee may exercise his or her rights under any outstanding Awards to the extent exercisable on the date of termination (but in no event later than the date of expiration of the term of such Award as set forth in the Award Agreement). To the extent that the

Awardee was not entitled to exercise his or her rights under such Awards at the date of such termination, or does not exercise such rights within the time specified in the individual Award Agreements, the Awards shall terminate, except as otherwise may be provided in the Award Agreement.

(c) Disability of Awardee. Notwithstanding the provisions of Section 12(b) above, in the event of termination of an Awardee's Continuous Status as a Participant as a result of total and permanent disability (i.e., by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of twelve (12) months): (i) the Awardee is unable to engage in any substantial gainful activity, or (ii) the Awardee has received income replacement benefits for at least three months under an accident and health plan covering Company employees):

(i) Any outstanding but unvested Stock Award shall become immediately vested (unless otherwise provided in the Award Agreement); and

(ii) Any outstanding Option or SAR shall vest, but only to the extent of the vesting that would have occurred had the Awardee remained in Continuous Status as a Participant for a period of twelve (12) months after the date on which the Participant ceased performing services as a result of the total and permanent disability. An Option or SAR that is vested pursuant to this Section 12(c) must be exercised within eighteen (18) months (or such shorter time as is specified in the grant) from the date on which the Participant ceased performing services as a result of the total and permanent disability (but in no event later than the date of expiration of the term of such Option or SAR as set forth in the Award Agreement). To the extent that the Awardee was not entitled to exercise such Option or SAR within the time specified herein, the Award shall terminate. This Section 12(c) shall only apply to a Conversion Option to the extent provided in the Award Agreement for the Conversion Option.

(d) Death of Awardee. Notwithstanding the provisions of Section 12(b) above, in the event of the death of an Awardee:

(i) who is at the time of death a Participant with an outstanding Stock Award, all unvested shares under any outstanding Awards shall become immediately vested (unless otherwise provided in the Award Agreement). Such shares may be claimed by the Awardee's estate or by a person who acquired the right to the shares by bequest or inheritance within twelve (12) months following the date of death. Any right to shares not claimed within twelve (12) months from the date of death shall be canceled.

(ii) who is at the time of death a Participant with an outstanding Option or SAR, the Option or SAR will vest, but only to the extent of the vesting that would have occurred had the Awardee continued living and remained in Continuous Status as a Participant twelve (12) months following the date of death. An Option or SAR that is vested pursuant to this Section 12(d)(i) may be exercised, at any time within twelve (12) months following the date of death, by the Awardee's estate or by a person who acquired the right to exercise the Award by bequest or inheritance; or

(iii) whose Option or SAR has not yet expired but whose Continuous Status as a Participant terminated prior to the date of death, the Option or SAR may be exercised, at any time within twelve (12) months following the date of death, by the Awardee's estate or by a person who acquired the right to exercise the Option or SAR by bequest or inheritance, but only to the extent of the right to exercise that had vested at the date of termination.

This Section 12(d) shall only apply to a Conversion Option to the extent provided in the Award Agreement for the Conversion Option.

(e) Notwithstanding subsections (b), (c), and (d) of this Section 12, the Board shall have the authority to extend the expiration date of any outstanding Option in circumstances in which it deems such action to be appropriate (provided that no such extension shall extend the term of an Award beyond the date on which the Award would have expired if no termination of the Employee's Continuous Status as a Participant had occurred).

13. Non-Transferability of Awards. An Award may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution and may be exercised, during the lifetime of the Awardee, only by the Awardee; provided that the Board may permit further transferability, on a general or specific basis, and may impose conditions and limitations on any permitted transferability.

14. Adjustments to Shares Subject to the Plan. If any change is made to the Shares by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Shares as a class without the Company's receipt of consideration, appropriate adjustments shall be made to (i) the maximum number and/or class of securities issuable under the Plan, (ii) the number and/or class of securities and/or the price per Share covered by outstanding Awards under the Plan, (iii) the Maximum Annual Participant Award, (iv) the maximum aggregate number of Shares underlying all Nonqualified Stock Options and SARs with a per Share exercise price of less than fair market value on any grant date that may be granted under the Plan, and (v) the maximum aggregate number of Shares underlying all Awards with a vesting period of less than three years. The Board may also make adjustments described in (i)-(v) of the previous sentence in the event of any distribution of assets to shareholders other than a normal cash dividend. In determining adjustments to be made under this Section 14, the Board may take into account such factors as it deems appropriate, including (i) the restrictions of applicable law, (ii) the potential tax consequences of an adjustment and (iii) the possibility that some Awardees might receive an adjustment and a distribution or other unintended benefit, and in light of such factors or circumstances may make adjustments that are not uniform or proportionate among outstanding Awards, modify vesting dates, defer the delivery of stock certificates or make other equitable adjustments. Any such adjustments to outstanding Awards will be effected in a manner that precludes the enlargement of rights and benefits under such Awards. Adjustments, if any, and any determinations or interpretations, including any determination of whether a distribution is other than a normal cash dividend, made by the Board shall be final, binding and conclusive. For purposes of this Section 14, conversion of any convertible securities of the Company shall not be deemed to have been effected without receipt of consideration. Except as expressly provided herein, no issuance by the Company of shares of any class, or securities convertible into shares of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of Shares subject to an Award.

In the event of the proposed dissolution or liquidation of the Company, the Award will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Board. The Board may, in the exercise of its sole discretion in such instances, declare that any Award shall terminate as of a date fixed by the Board and give each Awardee the right to exercise an Award as to all or any part of the Shares subject to an Award, including Shares as to which the Award would not otherwise be exercisable. In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, each Award shall be assumed or an equivalent award shall be substituted by such successor corporation or a parent or subsidiary of such successor corporation, unless such successor corporation does not agree to assume the Award or to substitute an equivalent award, in which case the Board shall, in lieu of such assumption or substitution, provide for the Awardee to have the right to exercise the Award as to all of the Shares subject to Awards, including Shares as to which the Award would not otherwise be exercisable. If the Board makes an Award fully exercisable in lieu of assumption or substitution in the event of a merger or sale of assets, the Board shall notify the Awardee that the Award shall be fully exercisable for a period of fifteen (15) days from the date of such notice, and the Award will terminate upon the expiration of such period.

15. Time of Granting Awards. The date of grant of an Award shall, for all purposes, be the date on which the Company completes the corporate action relating to the grant of such Award and all conditions to the grant have been satisfied, provided that conditions to the grant, exercise or vesting of an Award shall not defer the date of grant. Notice of a grant shall be given to each Participant to whom an Award is so granted within a reasonable time after the determination has been made.

16. Substitutions and Assumptions. The Board shall have the right to substitute or assume Awards in connection with mergers, reorganizations, separations, or other transactions to which Section 424(a) of the Code applies, provided such substitutions and assumptions are permitted by Section 424 of the Code and the regulations promulgated thereunder. The number of Shares reserved pursuant to Section 3 may be increased by the corresponding number of Awards assumed and, in the case of a substitution, by the net increase in the number of Shares subject to Awards before and after the substitution.

17. Amendment and Termination of the Plan.

(a) Amendment and Termination. The Board may amend or terminate the Plan from time to time in such respects as the Board may deem advisable (including, but not limited to amendments which the Board deems appropriate to enhance the Company's ability to claim deductions related to stock option exercises); provided that any increase in the number of Shares subject to the Plan, other than in connection with an adjustment under Section 14 of the Plan, and any amendment described in Section 10(c) of the Plan, shall require approval of or ratification by the shareholders of the Company.

(b) Participants in Foreign Countries. The Board shall have the authority to adopt such modifications, procedures, and subplans as may be necessary or desirable to comply with provisions of the laws of foreign countries in which the Company or its Subsidiaries may operate to assure the viability of the benefits from Awards granted to Participants performing services in such countries and to meet the objectives of the Plan.

(c) Effect of Amendment or Termination. Except as otherwise provided in Sections 4 and 14, any such amendment or termination of the Plan shall not affect Awards already granted and such Awards shall remain in full force and effect as if this Plan had not been amended or terminated, unless mutually agreed otherwise between the Awardee and the Board, which agreement must be in writing and signed by the Awardee and the Company.

18. Conditions Upon Issuance of Shares. Shares shall not be issued pursuant to the exercise of an Award unless the exercise of such Award and the issuance and delivery of such Shares pursuant thereto shall comply with all relevant provisions of law, including, without limitation, the Securities Act of 1933, as amended, the Exchange Act, the rules and regulations promulgated thereunder, and the requirements of any stock exchange upon which the Shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

19. Reservation of Shares. The Company, during the term of this Plan, will at all times reserve and keep available such number of Shares as shall be sufficient to satisfy the requirements of the Plan.

20. No Employment/Service Rights. Nothing in the Plan shall confer upon any Participant the right to an Award or to continue in service as an Employee or Consultant for any period of specific duration, or interfere with or otherwise restrict in any way the rights of the Company (or any Parent or Subsidiary employing or retaining such person), or of any Participant or Awardee, which rights are hereby expressly reserved by each, to terminate such person's services at any time for any reason, with or without cause.

* All share numbers in the Plan reflect the 2-for-1 stock split effected February 2003.

Exhibit 15

Microsoft Corporation
One Microsoft Way
Redmond, Washington

We have reviewed, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the unaudited interim financial information of Microsoft Corporation and subsidiaries for the periods ended December 31, 2011, and 2010, as indicated in our report dated January 19, 2012; because we did not perform an audit, we expressed no opinion on that information.

We are aware that our report referred to above, which is included in your Quarterly Report on Form 10-Q for the quarter ended December 31, 2011, is incorporated by reference in Registration Statement Nos. 333-120511, 333-109185, 333-06298, 333-16665, 333-118764, 333-75243, 333-91755, 333-52852, 333-102240, 33-36498, 33-45617, 333-132100, and 333-161516 of Microsoft Corporation on Form S-8 and Registration Statement Nos. 333-43449, 333-110107, 333-108843, and 333-155495 of Microsoft Corporation on Form S-3.

We also are aware that the aforementioned report, pursuant to Rule 436(c) under the Securities Act of 1933, is not considered a part of the Registration Statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of Sections 7 and 11 of that Act.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington

January 19, 2012

CERTIFICATIONS

I, Steven A. Ballmer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Microsoft Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ STEVEN A. BALLMER
Steven A. Ballmer
Chief Executive Officer

January 19, 2012

Exhibit 31.2

CERTIFICATIONS

I, Peter S. Klein, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Microsoft Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

/s/ PETER S. KLEIN

Peter S. Klein
Chief Financial Officer

January 19, 2012

Exhibit 32.1

CERTIFICATIONS PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the Quarterly Report of Microsoft Corporation, a Washington corporation (the "Company"), on Form 10-Q for the quarter ended December 31, 2011, as filed with the Securities and Exchange Commission (the "Report"), Steven A. Ballmer, Chief Executive Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ STEVEN A. BALLMER
Steven A. Ballmer
Chief Executive Officer

January 19, 2012

[A signed original of this written statement required by Section 906 has been provided to Microsoft Corporation and will be retained by Microsoft Corporation and furnished to the Securities and Exchange Commission or its staff upon request.]

Exhibit 32.2

CERTIFICATIONS PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the Quarterly Report of Microsoft Corporation, a Washington corporation (the “Company”), on Form 10-Q for the quarter ended December 31, 2011, as filed with the Securities and Exchange Commission (the “Report”), Peter S. Klein, Chief Financial Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ PETER S. KLEIN
Peter S. Klein
Chief Financial Officer

January 19, 2012

[A signed original of this written statement required by Section 906 has been provided to Microsoft Corporation and will be retained by Microsoft Corporation and furnished to the Securities and Exchange Commission or its staff upon request.]