MICROSOFT CORP
Form 10-Q
April 22, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2010

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

(425) 882-8080

(Registrant s telephone number, including area code)

None

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

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

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

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

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

Class	**Outstanding at April 19, 2010**
Common Stock, $0.00000625 par value per share	8,763,839,329 shares

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MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended March 31, 2010

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME STATEMENTS

(In millions, except per share amounts) (Unaudited)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	**2009**	**2010**	**2009**
Revenue	**$ 14,503**	$ 13,648	**$ 46,445**	$ 45,338
Operating expenses:				
Cost of revenue	**2,755**	2,814	**9,225**	9,569
Research and development	**2,220**	2,212	**6,364**	6,785
Sales and marketing	**3,203**	2,981	**9,612**	9,687
General and administrative	**1,152**	913	**3,017**	2,631
Employee severance	**0**	290	**59**	290
Total operating expenses	**9,330**	9,210	**28,277**	28,962
Operating income	**5,173**	4,438	**18,168**	16,376
Other income (expense)	**168**	(388)	**821**	(697)
Income before income taxes	**5,341**	4,050	**18,989**	15,679
Provision for income taxes	**1,335**	1,073	**4,747**	4,155
Net income	**$ 4,006**	$ 2,977	**$ 14,242**	$ 11,524
Earnings per share:				
Basic	**$ 0.46**	$ 0.33	**$ 1.61**	$ 1.29
Diluted	**$ 0.45**	$ 0.33	**$ 1.59**	$ 1.28
Weighted average shares outstanding:				
Basic	**8,767**	8,891	**8,846**	8,960
Diluted	**8,876**	8,904	**8,955**	9,008
Cash dividends declared per common share	**$ 0.13**	$ 0.13	**$ 0.39**	$ 0.39

See accompanying notes.

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BALANCE SHEETS

(In millions)	**March 31,**	**June 30,**
	2010 **(Unaudited)**	**2009** [1]
Assets		
Current assets:		
Cash and cash equivalents	**$ 8,155**	$ 6,076
Short-term investments (including securities loaned of **$2,480** and $1,540)	**31,511**	25,371
Total cash, cash equivalents, and short-term investments	**39,666**	31,447
Accounts receivable, net of allowance for doubtful accounts of **$381** and $451	**9,137**	11,192
Inventories	**501**	717
Deferred income taxes	**2,222**	2,213
Other	**2,992**	3,711
Total current assets	**54,518**	49,280
Property and equipment, net of accumulated depreciation of **$8,393** and $7,547	**7,372**	7,535
Equity and other investments	**7,797**	4,933
Goodwill	**12,463**	12,503
Intangible assets, net	**1,282**	1,759
Deferred income taxes	**0**	279
Other long-term assets	**1,478**	1,599
Total assets	**$ 84,910**	$ 77,888
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 3,279**	$ 3,324
Short-term debt	**2,249**	2,000
Accrued compensation	**2,885**	3,156
Income taxes	**901**	725
Short-term unearned revenue	**11,171**	13,003
Securities lending payable	**2,794**	1,684
Other	**3,145**	3,142
Total current liabilities	**26,424**	27,034
Long-term debt	**3,746**	3,746
Long-term unearned revenue	**1,089**	1,281
Deferred income taxes	**828**	0
Other long-term liabilities	**7,113**	6,269
Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **8,762** and 8,908	**62,517**	62,382
Retained deficit, including accumulated other comprehensive income of **$1,453** and $969	**(16,807)**	(22,824)

Total stockholders equity	**45,710**	39,558
Total liabilities and stockholders equity	**$ 84,910**	$ 77,888

(1) *Derived from audited financial statements.*
See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions) (Unaudited)	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009	Nine Months Ended March 31, 2010	Nine Months Ended March 31, 2009
Operations				
Net income	**$ 4,006**	$ 2,977	**$ 14,242**	$ 11,524
Adjustments to reconcile net income to net cash from operations:				
Depreciation, amortization, and other noncash items	**694**	664	**1,955**	1,881
Stock-based compensation	**481**	432	**1,409**	1,292
Net recognized losses (gains) on investments and derivatives	**(68)**	507	**(322)**	682
Excess tax benefits from stock-based compensation	**(14)**	(2)	**(38)**	(48)
Deferred income taxes	**(241)**	(368)	**263**	462
Deferral of unearned revenue	**6,087**	5,899	**19,692**	16,054
Recognition of unearned revenue	**(6,395)**	(6,670)	**(21,758)**	(19,078)
Changes in operating assets and liabilities:				
Accounts receivable	**1,947**	1,697	**1,906**	4,035
Other current assets	**(284)**	106	**306**	345
Other long-term assets	**(81)**	26	**(143)**	(159)
Other current liabilities	**897**	114	**(57)**	(3,824)
Other long-term liabilities	**364**	662	**1,014**	2,030
Net cash from operations	**7,393**	6,044	**18,469**	15,196
Financing				
Short-term borrowings (repayments), maturities of 90 days or less, net	**(349)**	(329)	**(446)**	1,667
Proceeds from issuance of debt, maturities longer than 90 days	**851**	328	**2,592**	328
Repayments of debt, maturities longer than 90 days	**(502)**	0	**(1,898)**	0
Common stock issued	**422**	112	**1,399**	436
Common stock repurchased	**(2,023)**	(18)	**(7,430)**	(9,331)
Common stock cash dividends	**(1,139)**	(1,155)	**(3,448)**	(3,310)
Excess tax benefits from stock-based compensation	**14**	2	**38**	48
Net cash used in financing	**(2,726)**	(1,060)	**(9,193)**	(10,162)
Investing				
Additions to property and equipment	**(408)**	(632)	**(1,219)**	(2,252)
Acquisition of companies, net of cash acquired	**(143)**	0	**(245)**	(827)
Purchases of investments	**(11,217)**	(10,683)	**(25,994)**	(21,525)
Maturities of investments	**1,054**	915	**6,448**	1,669
Sales of investments	**4,927**	3,327	**12,705**	16,102
Securities lending payable	**(117)**	1,064	**1,110**	(1,080)
Net cash used in investing	**(5,904)**	(6,009)	**(7,195)**	(7,913)
Effect of exchange rates on cash and cash equivalents	**(30)**	(36)	**(2)**	(175)

Net change in cash and cash equivalents	**(1,267)**	(1,061)	**2,079**	(3,054)
Cash and cash equivalents, beginning of period	**9,422**	8,346	**6,076**	10,339
Cash and cash equivalents, end of period	**$ 8,155**	$ 7,285	**$ 8,155**	$ 7,285

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions) (Unaudited)	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009	Nine Months Ended March 31, 2010	Nine Months Ended March 31, 2009
Common stock and paid-in capital				
Balance, beginning of period	**$ 62,566**	$ 61,392	**$ 62,382**	$ 62,849
Common stock issued	**372**	112	**1,399**	424
Common stock repurchased	**(495)**	(18)	**(2,151)**	(2,589)
Stock-based compensation	**481**	432	**1,409**	1,292
Stock-based compensation income tax deficiencies	**(410)**	(21)	**(524)**	(79)
Other, net	**3**	(1)	**2**	(1)
Balance, end of period	**62,517**	61,896	**62,517**	61,896
Retained deficit				
Balance, beginning of period	**(18,283)**	(26,914)	**(22,824)**	(26,563)
Net income	**4,006**	2,977	**14,242**	11,524
Other comprehensive income:				
Net unrealized gains (losses) on derivatives	**103**	36	**(258)**	802
Net unrealized gains (losses) on investments	**124**	67	**777**	(845)
Translation adjustments and other	**(97)**	38	**(36)**	(371)
Comprehensive income	**4,136**	3,118	**14,725**	11,110
Common stock cash dividends	**(1,132)**	(1,157)	**(3,429)**	(3,461)
Common stock repurchased	**(1,528)**	0	**(5,279)**	(6,039)
Balance, end of period	**(16,807)**	(24,953)	**(16,807)**	(24,953)
Total stockholders equity	**$ 45,710**	$ 36,943	**$ 45,710**	$ 36,943

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ACCOUNTING POLICIES

Basis of Presentation

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). 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 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.

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 2009 Form 10-K filed on July 30, 2009 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 but do not exercise control and are not the primary beneficiary 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.

Recently Adopted Accounting Guidance

In January 2010, the Financial Accounting Standards Board (FASB) issued guidance to amend the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance became effective for us with the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, adoption of this new guidance did not have a material impact on our financial statements. See Note 6 Fair Value Measurements.

On July 1, 2009, we adopted guidance issued by the FASB on business combinations. The guidance retains the fundamental requirements that the acquisition method of accounting (previously referred to as the purchase method of accounting) be used for all business combinations, but requires a number of changes, including changes in the way assets and liabilities are recognized and measured as a result of business combinations. It also requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. We have applied this guidance to business combinations completed since July 1, 2009.

On July 1, 2009, we adopted guidance issued by the FASB that changes the accounting and reporting for non-controlling interests. Non-controlling interests are to be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control are to be accounted for as equity transactions. In addition, net income attributable to a non-controlling interest is to be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, is to be recorded at fair value with any gain or loss recognized in net income. Adoption of the new guidance did not have a material impact on our financial statements.

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On July 1, 2009, we adopted guidance on fair value measurement for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Adoption of the new guidance did not have a material impact on our financial statements.

Recent Accounting Guidance Not Yet Adopted

In October 2009, the FASB issued guidance on revenue recognition that will become effective for us beginning July 1, 2010, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe adoption of this new guidance will not have a material impact on our financial statements.

In June 2009, the FASB issued guidance on the consolidation of variable interest entities, which is effective for us beginning July 1, 2010. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. We believe adoption of this new guidance will not have a material impact on our financial statements.

NOTE 2 EARNINGS PER SHARE

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of 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 earnings per share are as follows:

(In millions, except earnings per share)	**Three Months Ended March 31,**		**Nine Months Ended March 31,**	
	2010	**2009**	**2010**	**2009**
Net income available for common shareholders (A)	**$ 4,006**	$ 2,977	**$ 14,242**	$ 11,524
Weighted average shares of common stock outstanding (B)	**8,767**	8,891	**8,846**	8,960
Dilutive effect of stock-based awards	**109**	13	**109**	48
Common stock and common stock equivalents (C)	**8,876**	8,904	**8,955**	9,008
Earnings per share:				
Basic (A/B)	**$ 0.46**	$ 0.33	**$ 1.61**	$ 1.29
Diluted (A/C)	**$ 0.45**	$ 0.33	**$ 1.59**	$ 1.28

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

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	**2009**	**2010**	**2009**
Shares excluded from calculations of diluted EPS	**41**	518	**49**	352

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NOTE 3 OTHER INCOME (EXPENSE)

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

(In millions)	Three Months Ended March 31, 2010	2009	Nine Months Ended March 31, 2010	2009
Dividends and interest	**$ 166**	$ 164	**$ 490**	$ 546
Net recognized gains (losses) on investments	**137**	(452)	**299**	(53)
Net gains (losses) on derivatives	**(69)**	(55)	**23**	(629)
Net losses on foreign currency remeasurements	**(56)**	(26)	**(24)**	(555)
Other	**(10)**	(19)	**33**	(6)
Total	**$ 168**	$ (388)	**$ 821**	$ (697)

Other-than-temporary impairments included in Net recognized gains (losses) on investments were $12 million and $36 million for the three months and nine months ended March 31, 2010, respectively, as compared with $420 million and $754 million during the three months and nine months ended March 31, 2009, respectively.

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
March 31, 2010							
Cash	**$ 1,845**	**$**	**$**	**$ 1,845**	**$ 1,845**	**$**	**$**
Mutual funds	**1,277**			**1,277**	**1,277**		
Commercial paper	**1,603**			**1,603**	**1,429**	**174**	
Certificates of deposit	**2,884**			**2,884**	**2,649**	**235**	
U.S. government and agency securities	**19,902**	**88**	**(11)**	**19,979**	**485**	**19,494**	
Foreign government bonds	**606**	**11**	**(1)**	**616**		**616**	
Mortgage-backed securities	**3,522**	**96**	**(6)**	**3,612**		**3,612**	
Corporate notes and bonds	**6,837**	**296**	**(18)**	**7,115**	**350**	**6,765**	
Municipal securities	**734**	**4**	**(3)**	**735**	**120**	**615**	
Common and preferred stock	**5,764**	**1,645**	**(103)**	**7,306**			**7,306**

Other investments	**491**			**491**			**491**
Total	**$ 45,465**	**$ 2,140**	**$ (142)**	**$ 47,463**	**$ 8,155**	**$ 31,511**	**$ 7,797**

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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, 2009							
Cash	$ 2,064	$	$	$ 2,064	$ 2,064	$	$
Mutual funds	1,007		(25)	982	900	82	
Commercial paper	2,601			2,601	400	2,201	
Certificates of deposit	555			555	275	280	
U.S. government and agency securities	13,450	21	(5)	13,466	2,369	11,097	
Foreign government bonds	3,450	71	(4)	3,517		3,517	
Mortgage-backed securities	3,353	81	(16)	3,418		3,418	
Corporate notes and bonds	4,361	287	(52)	4,596		4,596	
Municipal securities	255	2	(1)	256	68	188	
Common and preferred stock	4,015	627	(182)	4,460			4,460
Other investments	465			465		(8)	473
Total	$ 35,576	$ 1,089	$ (285)	$ 36,380	$ 6,076	$ 25,371	$ 4,933

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			Total
(In millions)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
March 31, 2010						
U.S. government and agency securities	**$ 1,164**	**$ (11)**	**$**	**$**	**$ 1,164**	**$ (11)**
Foreign government bonds	**380**	**(1)**			**380**	**(1)**
Mortgage-backed securities	**233**	**(5)**	**19**	**(1)**	**252**	**(6)**
Corporate notes and bonds	**1,044**	**(10)**	**117**	**(8)**	**1,161**	**(18)**
Municipal securities	**115**	**(3)**			**115**	**(3)**
Common and preferred stock	**666**	**(45)**	**229**	**(58)**	**895**	**(103)**
Total	**$ 3,602**	**$ (75)**	**$ 365**	**$ (67)**	**$ 3,967**	**$ (142)**

	Less than 12 Months	12 Months or Greater	Total
(In millions)	Fair Value	Fair Value	Unrealized Losses

		Unrealized Losses		Unrealized Losses	Total Fair Value	
June 30, 2009						
Mutual funds	$ 3	$ (1)	$ 77	$ (24)	$ 80	$ (25)
U.S. government and agency securities	4,033	(5)			4,033	(5)
Foreign government bonds	1,444	(3)	669	(1)	2,113	(4)
Mortgage-backed securities	503	(16)			503	(16)
Corporate notes and bonds	713	(10)	504	(42)	1,217	(52)
Municipal securities	16	(1)			16	(1)
Common and preferred stock	1,154	(135)	120	(47)	1,274	(182)
Total	$ 7,866	$ (171)	$ 1,370	$ (114)	$ 9,236	$ (285)

At March 31, 2010 and June 30, 2009, the recorded bases and estimated fair values of common and preferred stock and other investments that are restricted for more than one year or are not publicly traded were $215 million and $204 million, respectively. The estimated fair values are based on publicly available market information or other estimates determined by management. Unrealized losses on fixed-income securities are primarily attributable to changes in interest rates. Unrealized losses on domestic and international equities are due to market price

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movements. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of March 31, 2010.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
Due in one year or less	$ 10,986	$ 10,999
Due after one year through five years	19,079	19,365
Due after five years through 10 years	2,016	2,082
Due after 10 years	4,008	4,100
Total	$ 36,089	$ 36,546

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 March 31, 2010 and June 30, 2009, the total notional amounts of these foreign exchange contracts sold were $10.6 billion and $7.2 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 March 31, 2010 and June 30, 2009, the total notional amounts of these foreign exchange contracts sold were $586 million and $3.5 billion, 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 March 31, 2010, the total notional amounts of these foreign exchange contracts purchased and sold were $3.5 billion and $3.5 billion, respectively. As of June 30, 2009, the total notional amounts of these foreign exchange contracts purchased and sold were $3.2 billion and $3.6 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of March 31, 2010, the total notional amounts of designated and non-designated equity contracts purchased and sold were $1.0 billion and $535 million, respectively. As of June 30, 2009, the total notional amounts of designated and non-designated equity contracts purchased and sold were immaterial.

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 March 31, 2010, the total notional amount of fixed-interest rate contracts purchased and sold were $2.8 billion and $2.1 billion, respectively. As of June 30, 2009, the total notional amounts of fixed-interest rate contracts purchased and sold were $2.7 billion and $456 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

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in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of March 31, 2010, the total notional derivative amount of mortgage contracts purchased was immaterial. As of June 30, 2009, the total notional derivative amount of mortgage contracts purchased was $1.3 billion.

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 March 31, 2010 and June 30, 2009, the total notional amounts of credit contracts purchased and sold were immaterial.

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 March 31, 2010, the total notional amounts of commodity contracts purchased and sold were $1.0 billion and $335 million, respectively. As of June 30, 2009, the total notional amounts of commodity contracts purchased and sold were $543 million and $33 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 March 31, 2010, our long-term unsecured debt rating was AAA, and cash investments were in excess of $1.0 billion. As a result, no collateral is required to be posted.

Fair Values of Derivative Instruments

Following are the gross fair values of derivative instruments held at March 31, 2010 and June 30, 2009, excluding 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
March 31, 2010						
Assets						
Derivatives not designated as hedging instruments:						
Short-term investments	$ 14	$ 131	$ 8	$ 7	$ 7	$ 167
Other current assets	54					54
Total	$ 68	$ 131	$ 8	$ 7	$ 7	$ 221
Derivatives designated as hedging instruments:						

Short-term investments	$ 1	$	$	$	$	$ 1
Other current assets	421					421
Total	$ 422	$	$	$	$	$ 422
Total assets	$ 490	$ 131	$ 8	$ 7	$ 7	$ 643

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(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
Liabilities						
Derivatives not designated as hedging instruments:						
Other current liabilities	**$ (67)**	**$ (9)**	**$ (6)**	**$ (42)**	**$ (12)**	**$ (136)**
Derivatives designated as hedging instruments:						
Other current liabilities	**$ (93)**	**$**	**$**	**$**	**$**	**$ (93)**
Total liabilities	**$ (160)**	**$ (9)**	**$ (6)**	**$ (42)**	**$ (12)**	**$ (229)**

(In millions)	Foreign Exchange Contracts	Equity Contracts	Interest Rate Contracts	Credit Contracts	Commodity Contracts	Total Derivatives
June 30, 2009						
Assets						
Derivatives not designated as hedging instruments:						
Short-term investments	$ 9	$ 78	$ 44	$ 21	$ 2	$ 154
Other current assets	48					48
Total	$ 57	$ 78	$ 44	$ 21	$ 2	$ 202
Derivatives designated as hedging instruments:						
Short-term investments	$ 12	$	$	$	$	$ 12
Other current assets	417					417
Equity and other investments		2				2
Total	$ 429	$ 2	$	$	$	$ 431
Total assets	$ 486	$ 80	$ 44	$ 21	$ 2	$ 633
Liabilities						
Derivatives not designated as hedging instruments:						
Other current liabilities	$ (183)	$ (3)	$ (20)	$ (62)	$ (6)	$ (274)
Derivatives designated as hedging instruments:						
Other current liabilities	$ (75)	$	$	$	$	$ (75)
Total liabilities	$ (258)	$ (3)	$ (20)	$ (62)	$ (6)	$ (349)

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

Fair-Value Hedges

For a derivative instrument designated as a fair-value hedge, the gain (loss) is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item 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.

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

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	2009	2010	2009
Foreign exchange contracts				
Derivatives	**$ (2)**	$ 195	**$ (106)**	$ 280
Hedged items	**4**	(190)	**107**	(276)
Total	**$ 2**	$ 5	**$ 1**	$ 4
Equity contracts				
Derivatives	**$**	$	**$**	$ 191
Hedged items				(211)
Total	**$**	$	**$**	$ (20)

Cash-Flow Hedges

For a derivative instrument designated as a cash-flow hedge, 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.

We recognized the following gains (losses) related to foreign exchange contracts designated as cash flow hedges (our only cash flow hedges during the period):

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	2009	2010	2009
Effective portion				
Gain (loss) recognized in OCI, net of tax effect of **$85** for the three months ended and $**(26)** for the nine months ended March 31, 2010, and $111 for the three months and $640 for the nine months ended March 31, 2009	**$ 159**	$ 206	**$ (48)**	$ 1,188
Gain reclassified from accumulated OCI into revenue	**85**	261	**322**	594

Amount excluded from effectiveness assessment and ineffective portion				
Loss recognized in other income (expense)	**(62)**	(100)	**(76)**	(294)

We estimate that $197 million of net derivative gains included in OCI will be reclassified into earnings within the next 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 months and nine months ended March 31, 2010 and 2009.

Non-Designated Derivatives

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 three months and nine months ended March 31, 2010 and 2009. 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, 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).

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(In millions)	Three Months Ended March 31, 2010	2009	Nine Months Ended March 31, 2010	2009
Foreign exchange contracts	**$ 1**	$ 11	**$ 91**	$ (139)
Equity contracts	**8**	(11)	**24**	(160)
Interest-rate contracts	**8**	47	**20**	(7)
Credit contracts	**7**	9	**18**	(26)
Commodity contracts	**(35)**	(8)	**34**	(188)
Total	**$ (11)**	$ 48	**$ 187**	$ (520)

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 and agency securities, domestic and international equities, and exchange-traded mutual funds. Our Level 1 derivative assets and liabilities include those 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, certain agency securities, certificates of deposit, and commercial paper. Our Level 2 derivative assets and liabilities primarily include certain over-the-counter option, futures, 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.

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Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present the fair values 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[1]	Net Fair Value
March 31, 2010						
Assets						
Mutual funds	**$ 1,277**	**$**	**$**	**$ 1,277**	**$**	**$ 1,277**
Commercial paper		**1,607**		**1,607**		**1,607**
Certificates of deposit		**2,884**		**2,884**		**2,884**
U.S. government and agency securities	**16,535**	**3,443**		**19,978**		**19,978**
Foreign government bonds	**232**	**387**		**619**		**619**
Mortgage-backed securities		**3,613**		**3,613**		**3,613**
Corporate notes and bonds		**6,796**	**194**	**6,990**		**6,990**
Municipal securities		**735**		**735**		**735**
Common and preferred stock	**7,043**	**43**	**5**	**7,091**		**7,091**
Derivatives	**14**	**623**	**6**	**643**	**(183)**	**460**
Total	**$ 25,101**	**$ 20,131**	**$ 205**	**$ 45,437**	**$ (183)**	**$ 45,254**
Liabilities						
Derivatives	**$ 11**	**$ 218**	**$**	**$ 229**	**$ (182)**	**$ 47**

(1) *This table includes the impact of netting derivative assets and derivative liabilities when a legally enforceable master netting agreement exists. These amounts also include fair value adjustments related to our own credit risk and counterparty credit risk.*

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting[1]	Net Fair Value
June 30, 2009						
Assets						
Mutual funds	$ 982	$	$	$ 982	$	$ 982
Commercial paper		2,601		2,601		2,601
Certificates of deposit		555		555		555
U.S. government and agency securities	7,134	6,105		13,239		13,239
Foreign government bonds	501	3,022		3,523		3,523
Mortgage-backed securities		3,593		3,593		3,593
Corporate notes and bonds		4,073	253	4,326		4,326
Municipal securities		256		256		256
Common and preferred stock	4,218	28	5	4,251		4,251

Derivatives	5	623	5	633	(235)	398
Total	$ 12,840	$ 20,856	$ 263	$ 33,959	$ (235)	$ 33,724
Liabilities						
Derivatives	$ 5	$ 344	$	$ 349	$ (231)	$ 118

(1) *This table includes the impact of netting derivative assets and derivative liabilities when a legally enforceable master netting agreement exists. These amounts also include fair value adjustments related to our own credit risk and counterparty credit risk.*

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The table below reconciles the total Net Fair Value of assets above to the balance sheet presentation in Note 4 for March 31, 2010 and June 30, 2009.

(In millions)	March 31, 2010	June 30, 2009
Net fair value of assets measured at fair value on a recurring basis	**$ 45,254**	$ 33,724
Cash	**1,845**	2,064
Common and preferred stock measured at fair value on a nonrecurring basis	**215**	204
Other investments measured at fair value on a nonrecurring basis	**491**	465
Derivative assets classified as other current assets	**(475)**	(465)
Derivative liabilities classified as other current assets	**148**	231
Other	**(15)**	157
Recorded basis of investment components	**$ 47,463**	$ 36,380

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

The following tables present the changes during the three months and nine months ended March 31, 2010 and 2009 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 other comprehensive income.

(In millions)	Corporate Notes and Bonds	Common and Preferred Stock	Derivative Assets	Total
Three Months and Nine Months Ended March 31, 2010				
Balance as of June 30, 2009	**$ 253**	**$ 5**	**$ 5**	**$ 263**
Total realized and unrealized gains (losses):				
Included in other income (expense)	**1**		**(2)**	**(1)**
Included in other comprehensive income	**(74)**			**(74)**
Balance as of September 30, 2009	**$ 180**	**$**		