ESSA Bancorp, Inc.
Form 10-Q
May 09, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2016

OR

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________ to __________

Commission File No. 001-33384

ESSA Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania	**20-8023072**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
200 Palmer Street, Stroudsburg, Pennsylvania	**18360**
(Address of Principal Executive Offices)	**(Zip Code)**

(570) 421-0531

(Registrant s telephone number)

N/A

(Former name or former address, 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 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 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 definition of large accelerated filer and accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	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

As of May 4, 2016 there were 11,379,664 shares of the Registrant s common stock, par value $0.01 per share, outstanding.

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Part I. Financial Information

Item 1. Financial Statements

ESSA BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEET

(UNAUDITED)

	March 31, 2016	September 30, 2015
	(dollars in thousands)	
Cash and due from banks	$ 20,917	$ 15,905
Interest-bearing deposits with other institutions	2,966	2,853
Total cash and cash equivalents	23,883	18,758
Certificates of deposit	1,500	1,750
Investment securities available for sale, at fair value	389,603	379,407
Loans receivable (net of allowance for loan losses of $9,415 and $8,919)	1,235,613	1,102,118
Regulatory stock, at cost	15,492	13,831
Premises and equipment, net	17,185	16,553
Bank-owned life insurance	31,119	30,655
Foreclosed real estate	2,316	2,480
Intangible assets, net	2,852	1,759
Goodwill	13,801	10,259
Deferred income taxes	11,537	11,149
Other assets	18,388	17,825
TOTAL ASSETS	$ 1,763,289	$ 1,606,544
LIABILITIES		
Deposits	$ 1,210,106	$ 1,096,754
Short-term borrowings	126,243	91,339
Other borrowings	230,601	229,101
Advances by borrowers for taxes and insurance	8,514	4,273
Other liabilities	13,264	13,797
TOTAL LIABILITIES	1,588,728	1,435,264
STOCKHOLDERS EQUITY		
Preferred Stock ($.01 par value; 10,000,000 shares authorized, none issued)		
Common stock ($.01 par value; 40,000,000 shares authorized, 18,133,095 issued; 11,367,654 and 11,353,244 outstanding at March 31, 2016 and September 30, 2015)	181	181

Additional paid in capital	182,021	182,295
Unallocated common stock held by the Employee Stock Ownership Plan (ESOP)	(9,400)	(9,627)
Retained earnings	85,875	83,658
Treasury stock, at cost; 6,765,441 and 6,779,851 shares outstanding at March 31, 2016 and September 30, 2015, respectively	(82,679)	(82,832)
Accumulated other comprehensive loss	(1,437)	(2,395)
TOTAL STOCKHOLDERS EQUITY	174,561	171,280
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,763,289	$ 1,606,544

See accompanying notes to the unaudited consolidated financial statements.

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ESSA BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF INCOME

(UNAUDITED)

	For the Three Months Ended March 31,		For the Six Months Ended March 31,	
	2016	**2015**	**2016**	**2015**
	(dollars in thousands, except per share data)		**(dollars in thousands, except per share data)**	
INTEREST INCOME				
Loans receivable, including fees	$ 12,805	$ 11,100	$ 24,379	$ 22,549
Investment securities:				
Taxable	1,903	1,799	3,721	3,688
Exempt from federal income tax	255	239	499	473
Other investment income	196	442	375	578
Total interest income	15,159	13,580	28,974	27,288
INTEREST EXPENSE				
Deposits	1,944	1,878	3,789	3,843
Short-term borrowings	115	103	209	206
Other borrowings	816	597	1,600	1,187
Total interest expense	2,875	2,578	5,598	5,236
NET INTEREST INCOME	12,284	11,002	23,376	22,052
Provision for loan losses	600	525	1,200	975
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	11,684	10,477	22,176	21,077
NONINTEREST INCOME				
Service fees on deposit accounts	875	757	1,738	1,584
Services charges and fees on loans	297	274	577	589
Trust and investment fees	194	204	407	442
Gain on sale of investments	365	204	368	204
Earnings on Bank-owned life insurance	234	231	464	470
Insurance commissions	217	217	416	399
Other	95	14	124	27
Total noninterest income	2,277	1,901	4,094	3,715
NONINTEREST EXPENSE				

Compensation and employee benefits	6,003	5,232	11,581	10,346
Occupancy and equipment	1,422	1,134	2,531	2,115
Professional fees	672	407	1,125	921
Data processing	1,079	892	1,998	1,705
Advertising	153	224	240	352
Federal Deposit Insurance Corporation (FDIC) premiums	322	289	600	581
(Gain)/loss on foreclosed real estate	161	(137)	151	(175)
Merger related costs			245	
Amortization of intangible assets	223	163	397	329
Other	1,071	894	2,024	1,890
Total noninterest expense	11,106	9,098	20,892	18,064
Income before income taxes	2,855	3,280	5,378	6,728
Income taxes	726	848	1,292	1,700
NET INCOME	$ 2,129	$ 2,432	$ 4,086	$ 5,028
Earnings per share				
Basic	$ 0.20	$ 0.23	$ 0.39	$ 0.48
Diluted	$ 0.20	$ 0.23	$ 0.39	$ 0.48
Dividends per share	$ 0.09	$ 0.09	$ 0.18	$ 0.16

See accompanying notes to the unaudited consolidated financial statements.

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ESSA BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2016	**2015**	**2016**	**2015**
	(dollars in thousands)		(dollars in thousands)	
Net income	$ 2,129	$ 2,432	$ 4,086	$ 5,028
Other comprehensive income:				
Investment securities available for sale:				
Unrealized holding gain	4,981	2,374	1,581	5,112
Tax effect	(1,694)	(807)	(538)	(1,737)
Reclassification of gains recognized in net income	(365)	(204)	(368)	(204)
Tax effect	124	69	125	69
Net of tax amount	3,046	1,432	800	3,240
Pension plan adjustment:				
Related to actuarial losses	119	60	239	120
Tax effect	(40)	(20)	(81)	(40)
Net of tax amount	79	40	158	80
Total other comprehensive income	3,125	1,472	958	3,320
Comprehensive income	$ 5,254	$ 3,904	$ 5,044	$ 8,348

See accompanying notes to the unaudited consolidated financial statements.

ESSA BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(UNAUDITED)

	Common Stock							
	Number of Shares	Amount	Additional Paid In Capital	Unallocated Common Stock Held by the ESOP	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
				(dollars in thousands)				
Balance, September 30, 2015	11,353,244	$ 181	$ 182,295	$ (9,627)	$ 83,658	$ (82,832)	$ (2,395)	$ 171,280
Net income					4,086			4,086
Other comprehensive income							958	958
Cash dividends declared ($.18 per share)					(1,869)			(1,869)
Stock based compensation			79					79
Allocation of ESOP stock			76	227				303
Allocation of treasury shares to incentive plan	37,110		(429)			429		
Treasury shares purchased	(22,700)					(276)		(276)
Balance, March 31, 2016	11,367,654	$ 181	$ 182,021	$ (9,400)	$ 85,875	$ (82,679)	$ (1,437)	$ 174,561

See accompanying notes to the unaudited consolidated financial statements.

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ESSA BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)

	For the Six Months Ended March 31,	
	2016	2015
	(dollars in thousands)	
OPERATING ACTIVITIES		
Net income	$ 4,086	$ 5,028
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,200	975
Provision for depreciation and amortization	876	641
Amortization and accretion of discounts and premiums, net	1,750	145
Gain on sale of investment securities	(368)	(204)
Compensation expense on ESOP	303	269
Stock based compensation	79	51
(Increase) decrease in accrued interest receivable	(477)	159
Increase/(decrease) in accrued interest payable	146	(18)
Earnings on bank-owned life insurance	(464)	(470)
Deferred federal income taxes	166	(339)
Increase in accrued pension liability	590	233
(Gain)/loss on foreclosed real estate, net	151	(175)
Amortization of identifiable intangible assets	398	329
Other, net	(223)	1,987
Net cash provided by operating activities	8,213	8,611
INVESTING ACTIVITIES		
Certificates of deposit maturities	250	15
Investment securities available for sale:		
Proceeds from sale of investment securities	29,022	3,319
Proceeds from principal repayments and maturities	47,903	30,318
Purchases	(50,016)	(29,317)
Increase in loans receivable, net	(13,040)	(22,416)
Redemption of regulatory stock	6,940	7,441
Purchase of regulatory stock	(7,712)	(6,801)
Proceeds from sale of foreclosed real estate	739	2,031
Acquisition, net of cash acquired	(16,174)	
Capital improvements to foreclosed real estate		13
Purchase of premises, equipment, and software	(579)	(454)
Net cash used for investing activities	(2,667)	(15,851)

FINANCING ACTIVITIES		
Decrease in deposits, net	(38,921)	(30,092)
Net increase in short-term borrowings	34,904	1,981
Proceeds from other borrowings	52,300	37,860
Repayment of other borrowings	(50,800)	(9,200)
Increase in advances by borrowers for taxes and insurance	4,241	4,472
Purchase of treasury stock shares	(276)	(1,803)
Dividends on common stock	(1,869)	(1,669)
Net cash provided by (used for) financing activities	(421)	1,549
Increase (decrease) in cash and cash equivalents	5,125	(5,691)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	18,758	22,301
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 23,883	$ 16,610

	For the Six Months Ended March 31,	
	2016	2015
	(dollars in thousands)	
SUPPLEMENTAL CASH FLOW DISCLOSURES		
Cash Paid:		
Interest	$ 5,388	$ 5,253
Income taxes	500	
Noncash items:		
Transfers from loans to foreclosed real estate	726	1,589
Acquisition of Eagle National Bank assets and liabilities		
Noncash assets acquired		
Investment securities, available for sale	36,275	
Loans receivable	123,380	
Federal Home Loan Bank stock	889	
Premises and equipment	945	
Accrued interest receivable	185	
Intangible assets	1,491	
Goodwill	3,542	
Deferred tax assets	715	
Other assets	1,989	
Liabilities assumed:		
Certificates of deposit	32,408	
Deposits other than certificates of deposit	119,865	
Accrued interest payable	64	
Other liabilities	900	
Net noncash assets acquired	16,174	
Cash acquired	8,481	

See accompanying notes to the unaudited consolidated financial statements.

ESSA BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

(unaudited)

1. Nature of Operations and Basis of Presentation

The consolidated financial statements include the accounts of ESSA Bancorp, Inc. (the Company), its wholly owned subsidiary, ESSA Bank & Trust (the Bank), and the Bank s wholly owned subsidiaries, ESSACOR Inc.; Pocono Investments Company; ESSA Advisory Services, LLC; Integrated Financial Corporation; and Integrated Abstract Incorporated, a wholly owned subsidiary of Integrated Financial Corporation. The primary purpose of the Company is to act as a holding company for the Bank. On November 6, 2014, the Company converted its status from a savings and loan holding company to a bank holding company. In addition, the Bank converted from a Pennsylvania-chartered savings association to a Pennsylvania-chartered savings bank. The Bank s primary business consists of the taking of deposits and granting of loans to customers generally in Monroe, Northampton, Lehigh, Delaware, Chester, Lackawanna, and Luzerne Counties, Pennsylvania. The Bank is subject to regulation and supervision by the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation. The investment in subsidiary on the parent company s financial statements is carried at the parent company s equity in the underlying net assets.

ESSACOR, Inc. is a Pennsylvania corporation that has been used to purchase properties at tax sales that represent collateral for delinquent loans of the Bank. Pocono Investment Company is a Delaware corporation formed as an investment company subsidiary to hold and manage certain investments, including certain intellectual property. ESSA Advisory Services, LLC is a Pennsylvania limited liability company owned 100 percent by ESSA Bank & Trust. ESSA Advisory Services, LLC is a full-service insurance benefits consulting company offering group services such as health insurance, life insurance, short-term and long-term disability, dental, vision, and 401(k) retirement planning as well as individual health products. Integrated Financial Corporation is a Pennsylvania Corporation that provided investment advisory services to the general public and is currently inactive. Integrated Abstract Incorporated is a Pennsylvania Corporation that provided title insurance services and is currently inactive. All significant intercompany accounts and transactions have been eliminated in consolidation.

The unaudited consolidated financial statements reflect all adjustments, which in the opinion of management, are necessary for a fair presentation of the results of the interim periods and are of a normal and recurring nature. Operating results for the six month period ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending September 30, 2016.

2. Earnings per Share

The following table sets forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computation for the three and six month periods ended March 31, 2016 and 2015.

	Three months ended	**Six months ended**

	March 31, 2016	March 31, 2015	March 31, 2016	March 31, 2015
Weighted-average common shares outstanding	18,133,095	18,133,095	18,133,095	18,133,095
Average treasury stock shares	(6,793,799)	(6,695,606)	(6,793,553)	(6,652,080)
Average unearned ESOP shares	(933,558)	(978,835)	(939,247)	(984,555)
Average unearned non-vested shares	(20,584)	(16,344)	(24,681)	(16,590)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	10,385,154	10,442,310	10,375,614	10,479,870
Additional common stock equivalents (non-vested stock) used to calculate diluted earnings per share	444	386		
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	139,100	78,451	140,155	42,727
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	10,524,697	10,521,147	10,515,770	10,522,597

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At March 31, 2016 there were 48,498 shares of nonvested stock outstanding at an average weighted price of $12.90 per share that were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive. At March 31, 2015 there were 15,290 shares of nonvested stock outstanding at a price of $11.07 per share and options to purchase 1,317,910 shares of common stock outstanding at a price of $12.35 per share that were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive.

3. Use of Estimates in the Preparation of Financial Statements

The accounting principles followed by the Company and its subsidiaries and the methods of applying these principles conform to U.S. generally accepted accounting principles (GAAP) and to general practice within the banking industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the Consolidated Balance Sheet date and related revenues and expenses for the period. Actual results could differ from those estimates.

4. Recent Accounting Pronouncements:

Recent Accounting Pronouncements:

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers* (a new revenue recognition standard). The Update s core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The Company is evaluating the effect of adopting this new accounting.

In June 2014, the FASB issued ASU 2014-12, *Compensation Stock Compensation (Topic 718): Accounting for Share-Based Payments when the Terms of an Award Provide that a Performance Target Could Be Achieved After the Requisite Service Period*. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this Update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying this Update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost. This Update did not have a significant impact on the Company s financial statements.

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements Going Concern (Subtopic* 205-40). The amendments in this Update provide guidance in accounting principles generally accepted in the United States of America about management s responsibility to evaluate whether there is substantial doubt about an entity s ability to continue as a going concern and to provide related footnote disclosures. The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. This Update is not expected to have a significant impact on the Company s financial

statements.

In November 2014, the FASB issued ASU 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (a consensus of the FASB Emerging Issues Task Force).* This Update clarifies how current U.S. GAAP should be interpreted in subjectively evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Public business entities are required to implement the new requirements in fiscal years and interim periods within those fiscal years beginning after December 15, 2015. This Update is not expected to have a significant impact on the Company s financial statements.

In January 2015, the FASB issued ASU 2015-01, *Income Statement Extraordinary and Unusual Items,* as part of its initiative to reduce complexity in accounting standards. This Update eliminates from U.S. GAAP the concept of extraordinary items. The amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively. A reporting entity may also apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. This Update is not expected to have a significant impact on the Company s financial statements.

In February 2015, the FASB issued ASU 2015-02, *Consolidation (Topic 810)*. The amendments in this Update affect reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. Specifically, the amendments (1) modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities; (2) eliminate the presumption that a general partner should consolidate a limited partnership; (3) affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related-party relationships; and (4) provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. The amendments in this Update are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. This Update is not expected to have a significant impact on the Company s financial statements.

In April 2015, the FASB issued ASU 2015-03, *Interest Imputation of Interest (Subtopic 835-30)*, as part of its initiative to reduce complexity in accounting standards. To simplify presentation of debt issuance costs, the amendments in this Update require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this Update. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. An entity should apply the new guidance on a retrospective basis, wherein the balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. This Update is not expected to have a significant impact on the Company s financial statements.

In April 2015, the FASB issued ASU 2015-04, *Compensation Retirement Benefits (Topic 715),* as part of its initiative to reduce complexity in accounting standards. For an entity with a fiscal year-end that does not coincide with a month-end, the amendments in this Update provide a practical expedient that permits the entity to measure defined benefit plan assets and obligations using the month-end that is closest to the entity s fiscal year-end and apply that practical expedient consistently from year to year. The practical expedient should be applied consistently to all plans if an entity has more than one plan. The amendments in this Update are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Earlier application is permitted. This Update is not expected to have a significant impact on the Company s financial statements.

In May 2015, the FASB issued ASU 2015-09, *Financial Services Insurance (Topic 944): Disclosure About Short-Duration Contracts*. The amendments apply to all insurance entities that issue short-duration contracts as defined in Topic 944, *Financial Services Insurance*. The amendments require insurance entities to disclose for annual reporting periods certain information about the liability for unpaid claims and claim adjustment expenses. The amendments also require insurance entities to disclose information about significant changes in methodologies and assumptions used to calculate the liability for unpaid claims and claim adjustment expenses, including reasons for the change and the effects on the financial statements. Additionally, the amendments require insurance entities to disclose for annual and interim reporting periods a rollforward of the liability for unpaid claims and claim adjustment

expenses, described in Topic 944. For health insurance claims, the amendments require the disclosure of the total of incurred-but-not-reported liabilities plus expected development on reported claims included in the liability for unpaid claims and claim adjustment expenses. For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. For all other entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017. This Update is not expected to have a significant impact on the Company s financial statements.

In June 2015, the FASB issued ASU 2015-10, *Technical Corrections and Improvements*. The amendments in this Update represent changes to clarify the FASB Accounting Standards Codification (Codification), correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. Transition guidance varies based on the amendments in this Update. The amendments in this Update that require transition guidance are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. All other amendments will be effective upon the issuance of this Update. This Update is not expected to have a significant impact on the Company s financial statements.

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In August 2015, the FASB issued ASU 2015-14, *Revenue from Contract with Customers* (*Topic 606*). The amendments in this Update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. The Company is evaluating the effect of adopting this new accounting Update.

In September 2015, the FASB issued ASU 2015-16, *Business Combinations (Topic 805).* The amendments in this Update require that an acquirer recognizes adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this Update require that the acquirer record, in the same period s financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this Update require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. This Update is not expected to have a significant impact on the Company s financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. The amendments in this Update require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments in this Update apply to all entities that present a classified statement of financial position. For public business entities, the amendments in this Update are effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments in this Update are effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Earlier application is permitted for all entities as of the beginning of an interim or annual reporting period. The amendments in this Update may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. This Update is not expected to have a significant impact on the Company s financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the

liability at fair value in accordance with the fair value option for financial instruments; (g) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (h) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity s other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of the standard will have on the Company s financial position or results of operations.

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In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which: (a) the lease term is 12 months or less, and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact the adoption of the standard will have on the Company s financial position or results of operations.

In March 2016, the FASB issued ASU 2016-04, *Liabilities Extinguishments of Liabilities (Subtopic 405-20).* The standard provides that liabilities related to the sale of prepaid stored-value products within the scope of this Update are financial liabilities. The amendments in the Update provide a narrow scope exception to the guidance in Subtopic 405-20 to require that breakage for those liabilities be accounted for consistent with the breakage guidance in Topic 606. The amendments in this Update are effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Earlier application is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company s financial statements.

In March 2016, the FASB issued ASU 2016-05, *Derivatives and Hedging (Topic 815)*. The amendments in this Update apply to all reporting entities for which there is a change in the counterparty to a derivative instrument that has been designated as a heading instrument under Topic 815. The standards in this Update clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require designation of that hedging relationship provided that all other hedge accounting criteria continue to be met. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. An entity has an option to apply the amendments in this Update on either a prospective basis or a modified retrospective basis. Early adoption is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company s financial statements.

In March 2016, the FASB issued ASU 2016-06, *Derivatives and Hedging (Topic 815)*. The amendments apply to all entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. The amendments in this update clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt host. An entity performing the assessment under the amendments in this Update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For entities other than public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption

is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company s financial statements.

In March 2016, the FASB issued ASU 2016-07, *Investments Equity Method and Joint Ventures (Topic 323)*. The Update affects all entities that have an investment that becomes qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. The amendments in this Update eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. The amendments in this Update require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments in this Update are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted. This Update is not expected to have a significant impact on the Company s financial statements.

In March 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606).* The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services (that are an output of the entity s ordinary activities) in exchange for consideration. The amendments in this update do not change the core principle of the guidance in Topic 606; they simply clarify the implementation guidance on principal versus agent considerations. The amendments in this Update are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. The amendments in this Update affect the guidance in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606),* which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements of Update 2014-09. ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,* defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company s financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, *Compensation Stock Compensation (Topic 718)*. The amendments in this Update affect all entities that issue share-based payment awards to their employees. The standards in this Update provide simplification for several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as with equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. In addition to those simplifications, the amendments eliminate the guidance in Topic 718 that was indefinitely deferred shortly after the issuance of FASB Statement No. 123 (revised 2004), *Share-Based Payment*. This should not result in a change in practice because the guidance that is being superseded was never effective. For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for any entity in any interim or annual period. The Company is currently evaluating the impact the adoption of the standard will have on the Company s financial position or results of operations.

In April 2016, the FASB issued ASU 2016-10, *Revenue from Contracts with Customers (Topic 606).* The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services in exchange for consideration. The amendments in this Update do not change the core principle for revenue recognition in Topic 606. Instead, the amendments provide (1) more detailed guidance in a few areas and (2) additional implementation guidance and examples based on feedback the FASB received from its stakeholders. The amendments are expected to reduce the degree of judgment necessary to comply with Topic 606, which the FASB expects will reduce the potential for diversity arising in practice and reduce the cost and complexity of applying the guidance. The amendments in this Update affect the guidance in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)*: Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company s financial position or results of operations.

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5. Investment Securities

The amortized cost, gross unrealized gains and losses, and fair value of investment securities available for sale are summarized as follows (in thousands):

	March 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale				
Fannie Mae	$ 134,469	$ 1,965	$ (280)	$ 136,154
Freddie Mac	87,858	1,224	(155)	88,927
Governmental National Mortgage Association	14,160	88	(49)	14,199
Other mortgage-backed securities	2,409		(20)	2,389
Total mortgage-backed securities	238,896	3,277	(504)	241,669
Obligations of states and political subdivisions	55,272	2,324	(22)	57,574
U.S. government agency securities	32,968	363	(25)	33,306
Corporate obligations	34,852	411	(367)	34,896
Trust-preferred securities	1,628		(18)	1,610
Other debt securities	20,310	286	(73)	20,523
Total debt securities	383,926	6,661	(1,009)	389,578
Equity securities - financial services	25			25
Total	$ 383,951	$ 6,661	$ (1,009)	$ 389,603

	September 30, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale				
Fannie Mae	$ 130,476	$ 2,052	$ (541)	$ 131,987
Freddie Mac	88,514	1,063	(286)	89,291
Governmental National Mortgage Association	13,201	103	(52)	13,252
Other mortgage-backed securities	2,494		(17)	2,477
Total mortgage-backed securities	234,685	3,218	(896)	237,007
Obligations of states and political subdivisions	50,094	1,676	(145)	51,625
U.S. government agency securities	45,799	399	(12)	46,186
Corporate obligations	22,440	157	(237)	22,360
Trust-preferred securities	1,613	98		1,711
Other debt securities	20,313	216	(36)	20,493
Total debt securities	374,944	5,764	(1,326)	379,382

Equity securities - financial services	25			25
Total	$ 374,969	$ 5,764	$ (1,326)	$ 379,407

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The amortized cost and fair value of debt securities at March 31, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

	Available For Sale	
	Amortized Cost	Fair Value
Due in one year or less	$ 3,253	$ 3,264
Due after one year through five years	51,173	51,920
Due after five years through ten years	80,458	81,861
Due after ten years	249,042	252,533
Total	$ 383,926	$ 389,578

For the three months ended March 31, 2016, the Company realized gross gains of $365,000 on proceeds from the sale of investment securities of $11.7 million. For the six months ended March 31, 2016, the Company realized gross gains of $368,000 on proceeds from the sale of investment securities of $29.0 million. During the first quarter of 2016, the Company sold $16.2 million of investment securities which were acquired in the merger with Eagle National Bancorp, Inc (ENB). The Company realized no gain or loss from the sale of these securities. For the three and six months ended March 31, 2015, the Company realized gross gains of $204,000 on proceeds from the sale of investment securities of $3.3 million.

6. Unrealized Losses on Securities

The following table shows the Company s gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position (dollars in thousands):

	March 31, 2016						
	Number of Securities	Less than Twelve Months		Twelve Months or Greater		Total	
		Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fannie Mae	20	$ 7,962	$ (14)	$ 19,159	$ (266)	$ 27,121	$ (280)
Freddie Mac	11	1,489	(9)	12,964	(146)	14,453	(155)
Governmental National Mortgage Association	5	4,392	(46)	863	(3)	5,255	(49)
Other mortgage-backed securities	3			2,388	(20)	2,388	(20)
Obligations of states and political subdivisions	6	7,867	(22)			7,867	(22)
U.S. government agency securities	2	1,894	(25)			1,894	(25)
Corporate obligations	11	10,482	(330)	963	(37)	11,445	(367)

Trust-preferred securities	2	1,610	(18)			1,610	(18)
Other debt securities	8	5,386	(45)	2,542	(28)	7,928	(73)
Total	68	$ 41,082	$ (509)	$ 38,879	$ (500)	$ 79,961	$ (1,009)

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	September 30, 2015						
	Number of Securities	Less than Twelve Months		Twelve Months or Greater		Total	
		Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fannie Mae	22	$ 7,238	$ (28)	$ 23,609	$ (513)	$ 30,847	$ (541)
Freddie Mac	12	1,487	(1)	15,477	(285)	16,964	(286)
Governmental National Mortgage Association	2			2,209	(52)	2,209	(52)
Other mortgage-backed securities	3			2,477	(17)	2,477	(17)
Obligations of states and political subdivisions	14	9,184	(57)	4,667	(88)	13,851	(145)
U.S. government agency securities	3	3,246	(12)			3,246	(12)
Corporate obligations	10	9,263	(207)	970	(30)	10,233	(237)
Other debt securities	6	5,232	(26)	1,748	(10)	6,980	(36)
Total	72	$ 35,650	$ (331)	$ 51,157	$ (995)	$ 86,807	$ (1,326)

The Company s investment securities portfolio contains unrealized losses on securities, including mortgage-related instruments issued or backed by the full faith and credit of the United States government, or generally viewed as having the implied guarantee of the U.S. government, other mortgage backed securities, debt obligations of a U.S. state or political subdivision, corporate debt obligations, trust preferred securities and equity securities.

The Company reviews its position quarterly and has asserted that at March 31, 2016, the declines outlined in the above table represent temporary declines and the Company would not be required to sell the security before its anticipated recovery in market value.

The Company has concluded that any impairment of its investment securities portfolio is not other than temporary but is the result of interest rate changes that are not expected to result in the non-collection of principal and interest during the period.

7. Loans Receivable, Net and Allowance for Loan Losses

Loans receivable consist of the following (in thousands):

	March 31, 2016	September 30, 2015
Real estate loans:		
Residential	$ 602,085	$ 610,582
Construction	3,135	878
Commercial	286,684	200,004
Commercial	55,170	34,314
Obligations of states and political subdivisions	59,673	59,820
Home equity loans and lines of credit	46,613	39,903

Auto Loans	188,334	162,193
Other	3,334	3,343
	1,245,028	1,111,037
Less allowance for loan losses	9,415	8,919
Net loans	$ 1,235,613	$ 1,102,118

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Included in the March 31, 2016 balances are loans acquired from Eagle National Bank, as of the acquisition date of December 4, 2015 as follows:

	2015
Real estate loans:	
Residential	$ 10,743
Commercial	87,336
Commercial	16,604
Home equity loans and lines of credit	8,632
Other	65
Total loans	$ 123,380

Purchased loans acquired in a business combination are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses.

Upon acquisition, the Company evaluated whether each acquired loan (regardless of size) was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. The fair value of purchased credit-impaired loans, on the acquisition date of December 4, 2015, was determined, primarily based on the fair value of loan collateral. The carrying value of all purchased loans acquired with deteriorated credit quality was $6.0 million at March 31, 2016.

On the acquisition date, the preliminary estimate of the unpaid principal balance for all loans evidencing credit impairment acquired in the ENB acquisition was $3.5 million and the estimated fair value of the loans was $2.0 million. Total contractually required payments on these loans, including interest, at the acquisition date was $4.2 million. However, the Company s preliminary estimate of expected cash flows was $2.2 million. At such date, the Company established a credit risk related non-accretable discount (a discount representing amounts which are not expected to be collected from the customer nor liquidation of collateral) of $2.0 million relating to these impaired loans, reflected in the recorded net fair value. Such amount is reflected as a non-accretable fair value adjustment to loans. The Company further estimated the timing and amount of expected cash flows in excess of the estimated fair value and established an accretable discount of $240,000 on the acquisition date relating to these impaired loans.

The carrying value of the loans acquired and accounted for in accordance with ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, was determined by projecting discounted contractual cash flows. The table below presents the components of the purchase accounting adjustments related to the purchased impaired loans acquired in the ENB acquisition as of December 4, 2015 (in thousands):

Unpaid principal balance	$ 3,468
Interest	717
Contractual cash flows	4,185
Non-accretable discount	(1,973)

Expected cash flows	2,212
Accretable discount	(240)
Estimated fair value	$ 1,972

Changes in the accretable yield for purchased credit-impaired loans were as follows, since acquisition, for the periods ended March 31, 2016 and March 31, 2015:

	Six months ended March 31,	
	2016	**2015**
Balance at beginning of period	$ 258	$ 170
Reclassification, new additions and other	240	
Accretion	(133)	(14)
Balance at end of period	$ 365	$ 156

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The following table presents additional information regarding loans acquired and accounted for in accordance with ASC 310-30 (in thousands):

	March 31, 2016 Acquired Loans with Specific Evidence or Deterioration in Credit Quality (ASC 310-30)	September 30, 2015 Acquired Loans with Specific Evidence or Deterioration in Credit Quality (ASC 310-30)
Outstanding balance	$ 7,622	$ 4,779
Carrying amount	$ 5,995	$ 4,162

The following table shows the amount of loans in each category that was individually and collectively evaluated for impairment at the dates indicated (in thousands):

	Total Loans	Individually Evaluated for Impairment	Loans Acquired with Deteriorated Credit Quality	Collectively Evaluated for Impairment
March 31, 2016				
Real estate loans:				
Residential	$ 602,085	$ 10,008	$	$ 592,077
Construction	3,135			3,135
Commercial	286,684	13,679	4,958	268,047
Commercial	55,170	1,939	411	52,820
Obligations of states and political subdivisions	59,673			59,673
Home equity loans and lines of credit	46,613	640	626	45,347
Auto loans	188,334	707		187,627
Other	3,334	2		3,332
Total	$ 1,245,028	$ 26,975	$ 5,995	$ 1,212,058

	Total Loans	Individually Evaluated for Impairment	Loans Acquired with Deteriorated Credit Quality	Collectively Evaluated for Impairment
September 30, 2015				
Real estate loans:				
Residential	$ 610,582	$ 11,985	$	$ 598,597
Construction	878			878
Commercial	200,004	15,100	4,108	180,796
Commercial	34,314	204	54	34,056

Obligations of states and political subdivisions	59,820			59,820
Home equity loans and lines of credit	39,903	795		39,108
Auto loans	162,193	625		161,568
Other	3,343			3,343
Total	$ 1,111,037	$ 28,709	$ 4,162	$ 1,078,166

We maintain a loan review system that allows for a periodic review of our loan portfolio and the early identification of potential impaired loans. Such system takes into consideration, among other things, delinquency status, size of loans, type and market value of collateral and financial condition of the borrowers. Specific loan loss allowances are established for identified losses based on a review of such information. A loan evaluated for impairment is considered to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans identified as impaired are evaluated independently. We do not aggregate such loans for evaluation purposes. Impairment is measured on a loan-by-loan basis for commercial and construction loans by the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral-dependent.

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Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are part of a larger relationship that is impPAN="2" ALIGN="right">**Percentage Change 2013 Versus 2012**

Research and development	**$ 11,381**	$ 10,411	$ 9,811	9%	6%
As a percent of revenue	**13%**	13%	13%	0ppt	0ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code.

Fiscal year 2014 compared with fiscal year 2013

Research and development expenses increased $970 million or 9%, due mainly to increased investment in new products and services in our Devices engineering group, including $275 million of NDS expenses, and increased investment in our Applications and Services engineering group.

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Fiscal year 2013 compared with fiscal year 2012

Research and development expenses increased, reflecting a $460 million or 6% increase in headcount-related expenses, largely related to the Xbox Platform.

Sales and Marketing

(In millions, except percentages)	2014	2013	2012	Percentage Change 2014 Versus 2013	Percentage Change 2013 Versus 2012
Sales and marketing	**$ 15,811**	$ 15,276	$ 13,857	4%	10%
As a percent of revenue	**18%**	20%	19%	(2)ppt	1ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and the costs of advertising, promotions, trade shows, seminars, and other programs.

Fiscal year 2014 compared with fiscal year 2013

Sales and marketing expenses increased $535 million or 4%, primarily due to NDS expenses and increased investment in sales resources, offset in part by lower advertising costs. NDS sales and marketing expenses were $394 million during fiscal year 2014. Average headcount, excluding NDS, grew 4%. Advertising costs, excluding NDS, declined $403 million or 15%, primarily due to Windows 8 and Surface costs in the prior year.

Fiscal year 2013 compared with fiscal year 2012

Sales and marketing expenses grew, reflecting an $898 million increase in advertising costs associated primarily with Windows 8 and Surface, $181 million higher fees paid to third-party software advisors, and a $145 million or 2% increase in headcount-related expenses.

General and Administrative

(In millions, except percentages)	2014	2013	2012	Percentage Change 2014 Versus 2013	Percentage Change 2013 Versus 2012
General and administrative	**$ 4,821**	$ 5,149	$ 4,569	(6)%	13%
As a percent of revenue	**6%**	7%	6%	(1)ppt	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.

Fiscal year 2014 compared with fiscal year 2013

General and administrative expenses decreased $328 million or 6%, due mainly to the EU fine in the prior year, offset in part by higher business taxes, higher costs for internal use software capitalized in the prior year, and NDS expenses. NDS general and administrative expenses were $77 million during fiscal year 2014.

Fiscal year 2013 compared with fiscal year 2012

General and administrative expenses increased, primarily due to legal charges for the EU fine.

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Goodwill Impairment

We test goodwill for impairment annually on May 1 at the reporting unit level using a discounted cash flow methodology with a peer-based, risk-adjusted weighted average cost of capital. No impairment of goodwill was identified as of May 1, 2014 or May 2013. Our goodwill impairment test as of May 1, 2012, indicated that the carrying value of our previous Online Services Division reporting unit (in Devices and Consumer Other under our current segment structure) exceeded its estimated fair value. Accordingly, we recorded a non-cash, non-tax deductible goodwill impairment charge of $6.2 billion during the three months ended June 30, 2012, reducing the unit s goodwill from $6.4 billion to $223 million.

Integration and Restructuring

Integration and restructuring expenses consist of transaction fees and direct acquisition costs, including legal, finance, consulting, and other professional fees. Integration and restructuring expenses also include employee compensation and termination costs associated with certain reorganization activities.

Integration and restructuring expenses were $127 million for fiscal year 2014, reflecting expenses associated with the acquisition and integration of NDS.

OTHER INCOME (EXPENSE)

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

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Dividends and interest income	**$ 883**	$ 677	$ 800
Interest expense	**(597)**	(429)	(380)
Net recognized gains on investments	**437**	116	564
Net losses on derivatives	**(328)**	(196)	(364)
Net losses on foreign currency remeasurements	**(165)**	(74)	(117)
Other	**(169)**	194	1
Total	**$ 61**	$ 288	$ 504

We use derivative instruments to: manage risks related to foreign currencies, equity prices, interest rates, and credit; enhance investment returns; and facilitate portfolio diversification. Gains and losses from changes in fair values of derivatives that are not designated as hedges are primarily recognized in other income (expense). 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 other comprehensive income (OCI) until the securities are sold or other-than-temporarily impaired, at which time the amounts are reclassified from accumulated other comprehensive income (AOCI) into other income (expense).

Fiscal year 2014 compared with fiscal year 2013

Dividends and interest income increased due to higher portfolio balances. Interest expense increased due to higher outstanding long-term debt. Net recognized gains on investments increased primarily due to higher gains on sales of equity securities and lower other-than-temporary impairments. Other-than-temporary impairments were $106 million in fiscal year 2014, compared with $208 million in fiscal year 2013. Net losses on derivatives increased due to higher losses on foreign exchange contracts, losses on equity derivatives as compared to gains in the prior period, offset in part by gains on commodity and interest rate derivatives as compared to losses in the prior period. For fiscal year 2014, other reflects recognized losses from certain joint ventures, offset in part by a recognized gain on a divestiture. For fiscal year 2013, other reflects recognized gains on divestitures, including the gain recognized upon the divestiture of our 50% share in the MSNBC joint venture.

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Fiscal year 2013 compared with fiscal year 2012

Dividends and interest income decreased due to lower yields on our fixed-income investments, offset in part by higher average portfolio investment balances. Net recognized gains on investments decreased primarily due to lower gains on sales of equity and fixed-income securities and a gain recognized on the partial sale of our Facebook holding in the prior year, offset in part by lower other-than-temporary impairments. Other-than-temporary impairments were $208 million in fiscal year 2013, compared with $298 million in fiscal year 2012. Net losses on derivatives decreased due to gains on equity derivatives in the current fiscal year as compared with losses in the prior fiscal year, and lower losses on commodity and foreign exchange derivatives as compared to the prior fiscal year, offset in part by losses on interest-rate derivatives in the current fiscal year as compared to gains in the prior fiscal year. For the current year, other reflects recognized gains on divestitures, including the gain recognized upon the divestiture of our 50% share in the MSNBC joint venture.

INCOME TAXES

Fiscal year 2014 compared with fiscal year 2013

Our effective tax rate for fiscal years 2014 and 2013 was approximately 21% and 19%, respectively. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

Our fiscal year 2014 effective rate increased by 2% from fiscal year 2013 mainly due to adjustments of $458 million to prior years liabilities for intercompany transfer pricing that increased taxable income in more highly taxed jurisdictions, as well as losses incurred by NDS and changes in the geographic mix of our business. This was offset in part by favorable transfer pricing developments in certain foreign tax jurisdictions, primarily Denmark.

Changes in the mix of income before income taxes between the U.S. and foreign countries also impacted our effective tax rates and resulted primarily from changes in the geographic distribution of and changes in consumer demand for our products and services. We supply our Windows PC operating system to customers through our U.S. regional operating center, while we supply the Microsoft Office system and our server products and tools to customers through our foreign regional operations centers. Windows PC operating system revenue decreased $655 million in fiscal year 2014, while Microsoft Office system and server products and tools revenue increased $1.3 billion and $1.6 billion, respectively, during this same period. In fiscal years 2014 and 2013, our U.S. income before income taxes was $7.1 billion and $6.7 billion, respectively, and comprised 26% and 25%, respectively, of our income before income taxes. In fiscal years 2014 and 2013, the foreign income before income taxes was $20.7 billion and $20.4 billion, respectively, and comprised 74% and 75%, respectively, of our income before income taxes.

Tax contingencies and other tax liabilities were $10.4 billion and $9.4 billion as of June 30, 2014 and 2013, respectively, and are included in other long-term liabilities. This increase relates primarily to adjustments to prior years liabilities for intercompany transfer pricing and adjustments related to our IRS audits. 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 those years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of June 30, 2014, the primary unresolved issue relates to transfer pricing which could have a significant impact on our consolidated financial statements if not resolved favorably. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2013.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2013, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

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Fiscal year 2013 compared with fiscal year 2012

Our effective tax rate for fiscal years 2013 and 2012 was approximately 19% and 24%, respectively. Our effective tax rate was lower than the U.S. federal statutory rate primarily due to earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and Puerto Rico.

Our fiscal year 2013 effective rate decreased by 5% from fiscal year 2012 mainly due to a nonrecurring $6.2 billion non-tax deductible goodwill impairment charge that was recorded in fiscal year 2012. The goodwill impairment charge increased our effective tax rate by 10% in fiscal year 2012. In addition, in fiscal years 2013 and 2012, we recognized a reduction of 18% and 21%, respectively, to the effective tax rate due to foreign earnings taxed at lower rates. The decrease in our effective tax rate for fiscal year 2013 was primarily offset by a 1% increase related to the EU fine, which is not tax deductible.

Changes in the mix of income before income taxes between the U.S. and foreign countries also impacted our effective tax rates and resulted primarily from changes in the geographic distribution of and changes in consumer demand for our products and services. We supply our Windows PC operating system to customers through our U.S. regional operating center, while we supply the Microsoft Office system and our server products and tools to customers through our foreign regional operations centers. Windows PC operating system revenue increased $209 million in fiscal year 2013, while Microsoft Office system and server products and tools revenue increased $696 million and $1.2 billion, respectively, during this same period. In fiscal years 2013 and 2012, our U.S. income before income taxes was $6.7 billion and $1.6 billion, respectively, and comprised 25% and 7%, respectively, of our income before income taxes. In fiscal years 2013 and 2012, the foreign income before income taxes was $20.4 billion and $20.7 billion, respectively, and comprised 75% and 93%, respectively, of our income before income taxes. The primary driver for the increase in the U.S. income before income tax in fiscal year 2013 was the goodwill impairment charge recorded during the prior year.

Tax contingencies and other tax liabilities were $9.4 billion and $7.6 billion as of June 30, 2013 and 2012, respectively, and are included in other long-term liabilities. This increase relates primarily to transfer pricing, including transfer pricing developments in certain foreign tax jurisdictions, primarily Denmark. 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 those years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of June 30, 2013, the primary unresolved issue relates to transfer pricing which could have a significant impact on our consolidated 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 because we do not believe the remaining open issues will be resolved within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2012.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2012, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled $85.7 billion as of June 30, 2014, compared with $77.0 billion as of June 30, 2013. Equity and other investments were $14.6 billion as of June 30, 2014, compared with $10.8 billion as of June 30, 2013. 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

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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.

Of the cash, cash equivalents, and short-term investments at June 30, 2014, $77.1 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash, cash equivalents, and short-term investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was $2.6 billion. As of June 30, 2014, approximately 84% of the cash equivalents and short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 5% were invested in corporate notes and bonds of U.S. companies, and approximately 1% 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 $558 million as of June 30, 2014. Our average and maximum securities lending payable balances for the fiscal year were $619 million and $1.3 billion, respectively. Intra-year 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. government securities. 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, common and preferred stock, foreign government bonds, mortgage-backed securities, and certificates of deposit. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured at fair value on a recurring basis using unobservable inputs are an immaterial portion of our portfolio.

A majority of our investments are priced by pricing vendors and are generally Level 1 or Level 2 investments as these vendors either provide a quoted market price in an active market or use observable inputs for their pricing without applying significant adjustments. Broker pricing is used mainly when a quoted price is not available, the investment is not priced by our pricing vendors, or when a broker price is more reflective of fair values in the market in which the investment trades. Our broker-priced investments are generally classified as Level 2 investments because the broker prices these investments based on similar assets without applying significant adjustments. In addition, all 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

Fiscal year 2014 compared with fiscal year 2013

Cash flows from operations increased $3.4 billion during the current fiscal year to $32.2 billion, due mainly to increases in cash received from customers. Cash used in financing increased $246 million to $8.4 billion, due mainly to a $2.0 billion increase in cash used for common stock repurchases, a $1.4 billion increase in dividends paid, and a $324 million decrease in proceeds from the issuance of common stock, offset in part by a $3.4 billion increase in

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proceeds from issuances of debt, net of repayments. Cash used in investing decreased $5.0 billion to $18.8 billion, due mainly to a $10.5 billion decrease in cash used for net investment purchases, sales, and maturities, offset in part by a $4.4 billion increase in cash used for acquisition of companies and purchases of intangible and other assets, and a $1.2 billion increase in capital expenditures for property and equipment.

Fiscal year 2013 compared with fiscal year 2012

Cash flows from operations decreased $2.8 billion during the current fiscal year to $28.8 billion, due mainly to changes in working capital, including increases in inventory and other current assets. Cash used for financing decreased $1.3 billion to $8.1 billion, due mainly to a $3.5 billion increase in proceeds from issuances of debt, net of repayments, offset in part by a $1.1 billion increase in dividends paid and a $982 million decrease in proceeds from the issuance of common stock. Cash used in investing decreased $975 million to $23.8 billion, due mainly to an $8.5 billion decrease in cash used for acquisitions of companies and purchases of intangible and other assets, offset in part by a $5.8 billion increase in cash used for net investment purchases, maturities, and sales, and a $2.0 billion increase in cash used for additions to property and equipment.

Debt

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

As of June 30, 2014, we had $22.6 billion of issued and outstanding debt, comprising $2.0 billion of short-term debt and $20.6 billion of long-term debt.

Short-term debt

As of June 30, 2014, we had $2.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.12% and maturities ranging from 86 days to 91 days. The estimated fair value of this commercial paper approximates its carrying value.

We have a $5.0 billion credit facility that expires on November 14, 2018, which serves as a back-up for our commercial paper program. As of June 30, 2014, we were in compliance with the only financial covenant in the credit agreement, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreement. No amounts were drawn against the credit facility during any of the periods presented.

Long-term debt

As of June 30, 2014, the total carrying value and estimated fair value of our long-term debt were $20.6 billion and $21.5 billion, respectively. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt and the associated interest rates were as follows as of June 30, 2014:

Due Date	Face Value	Stated Interest Rate	Effective Interest Rate
	(In millions)		
Notes			
September 25, 2015	$ 1,750	1.625%	1.795%
February 8, 2016	750	2.500%	2.642%
November 15, 2017	600	0.875%	1.084%
May 1, 2018	450	1.000%	1.106%
December 6, 2018 [(a)]	1,250	1.625%	1.824%
June 1, 2019	1,000	4.200%	4.379%
October 1, 2020	1,000	3.000%	3.137%
February 8, 2021	500	4.000%	4.082%
December 6, 2021 [(b)]	2,396	2.125%	2.233%
November 15, 2022	750	2.125%	2.239%
May 1, 2023	1,000	2.375%	2.465%
December 15, 2023 [(a)]	1,500	3.625%	3.726%
December 6, 2028 [(b)]	2,396	3.125%	3.218%
May 2, 2033 [(c)]	753	2.625%	2.690%
June 1, 2039	750	5.200%	5.240%
October 1, 2040	1,000	4.500%	4.567%
February 8, 2041	1,000	5.300%	5.361%
November 15, 2042	900	3.500%	3.571%
May 1, 2043	500	3.750%	3.829%
December 15, 2043 [(a)]	500	4.875%	4.918%
Total	$ 20,745		

(a) *In December 2013, we issued $3.3 billion of debt securities.*
(b) *In December 2013, we issued 3.5 billion of debt securities.*
(c) *In April 2013, we issued 550 million of debt securities.*

The notes in this table are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. As of June 30, 2014, the aggregate unamortized discount for our long-term debt was $100 million.

Unearned Revenue

Unearned revenue at June 30, 2014 was comprised mainly of 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 coverage period and accounted for as subscriptions with revenue recognized ratably over the coverage period. Unearned revenue at June 30, 2014 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; Office 365 subscriptions; Bundled Offerings; Skype prepaid credits and subscriptions; 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.

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The following table outlines the expected future recognition of unearned revenue as of June 30, 2014:

(In millions)	
Three Months Ending,	
September 30, 2014	$ 8,667
December 31, 2014	7,380
March 31, 2015	4,812
June 30, 2015	2,291
Thereafter	2,008
Total	$ 25,158

Share Repurchases

On September 16, 2013, our Board of Directors approved a new share repurchase program authorizing up to $40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. As of June 30, 2014, $35.1 billion remained of the $40.0 billion share repurchase program.

During fiscal year 2014, we repurchased 175 million shares of Microsoft common stock for $6.4 billion; 128 million shares were repurchased for $4.9 billion under the share repurchase program approved by our Board of Directors on September 16, 2013 and 47 million shares were repurchased for $1.5 billion under the share repurchase program that was announced on September 22, 2008 and expired September 30, 2013. During fiscal years 2013 and 2012, we repurchased 158 million shares for $4.6 billion and 142 million shares for $4.0 billion, respectively, under the share repurchase program announced on September 22, 2008. All repurchases were made using cash resources.

Dividends

During fiscal years 2014 and 2013, our Board of Directors declared the following dividends:

Declaration Date	**Dividend Per Share**	**Record Date**	**Total Amount**	**Payment Date**
			(In millions)	
Fiscal Year 2014				
September 16, 2013	**$ 0.28**	**November 21, 2013**	**$ 2,332**	**December 12, 2013**
November 19, 2013	**$ 0.28**	**February 20, 2014**	**$ 2,322**	**March 13, 2014**
March 11, 2014	**$ 0.28**	**May 15, 2014**	**$ 2,309**	**June 12, 2014**
June 10, 2014	**$ 0.28**	**August 21, 2014**	**$ 2,307**	**September 11, 2014**
Fiscal Year 2013				
September 18, 2012	$ 0.23	November 15, 2012	$ 1,933	December 13, 2012

November 28, 2012	$ 0.23	February 21, 2013	$ 1,925	March 14, 2013
March 11, 2013	$ 0.23	May 16, 2013	$ 1,921	June 13, 2013
June 12, 2013	$ 0.23	August 15, 2013	$ 1,916	September 12, 2013

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. These obligations did not have a material impact on our consolidated financial statements during the periods presented.

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Contractual Obligations

The following table summarizes the payments due by fiscal year for our outstanding contractual obligations as of June 30, 2014:

(In millions)	2015	2016-2017	2018-2019	Thereafter	Total
Long-term debt: [(a)]					
Principal payments	$ 0	$ 2,500	$ 3,300	$ 14,945	$ 20,745
Interest payments	566	1,069	1,015	6,110	8,760
Construction commitments [(b)]	880	0	0	0	880
Operating leases [(c)]	878	1,419	1,054	1,063	4,414
Purchase commitments [(d)]	12,995	969	657	153	14,774
Other long-term liabilities [(e)]	0	354	80	393	827
Total contractual obligations	$ 15,319	$ 6,311	$ 6,106	$ 22,664	$ 50,400

(a) *See Note 12 Debt of the Notes to Financial Statements (Part II, Item 8 of this Form 10-K).*

(b) *These amounts represent commitments for the construction of buildings, building improvements, and leasehold improvements.*

(c) *These amounts represent undiscounted future minimum rental commitments under noncancellable facilities leases.*

(d) *These amounts represent purchase commitments, including all open purchase orders and all contracts that are take-or-pay contracts that are not presented as construction commitments above.*

(e) *We have excluded long-term tax contingencies, other tax liabilities, and deferred income taxes of $13.3 billion from the amounts presented. We have also excluded unearned revenue and non-cash items.*

Other Planned Uses of Capital

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. 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 expect capital expenditures to increase in coming years in support of our cloud and devices strategy. 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 dilution of our earnings. We have borrowed funds domestically and continue to believe we have the ability to do so at reasonable interest rates.

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RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance enhancing disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial 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. In January 2013, the FASB clarified that the scope of this guidance applies to derivatives, repurchase agreements, and securities lending arrangements that are either offset or subject to an enforceable master netting arrangement, or similar agreements. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 5 Derivatives of the Notes to Financial Statements.

In February 2013, the FASB issued guidance on disclosure requirements for items reclassified out of AOCI. This new guidance requires entities to present (either on the face of the income statement or in the notes to financial statements) the effects on the line items of the income statement for amounts reclassified out of AOCI. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 19 Accumulated Other Comprehensive Income of the Notes to Financial Statements.

Recent Accounting Guidance Not Yet Adopted

In March 2013, the FASB issued guidance on a parent s accounting for the cumulative translation adjustment upon derecognition of a subsidiary or group of assets within a foreign entity. This new guidance requires that the parent release any related cumulative translation adjustment into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The new guidance will be effective for us beginning July 1, 2014. We do not anticipate material impacts on our consolidated financial statements upon adoption.

In May 2014, as part of its ongoing efforts to assist in the convergence of U.S. GAAP and International Financial Reporting Standards, the FASB issued a new standard related to revenue recognition. Under the new standard, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The new standard will be effective for us beginning July 1, 2017 and early adoption is not permitted. We anticipate this standard will have a material impact on our consolidated financial statements, and we are currently evaluating its impact.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

Revenue Recognition

Revenue recognition for multiple-element arrangements requires judgment to determine if multiple elements exist, whether elements can be accounted for as separate units of accounting, and if so, the fair value for each of the elements.

Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. Certain volume licensing arrangements include a perpetual license for

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current products combined with rights to receive unspecified future versions of software products (Software Assurance) and are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period.

Software updates are evaluated on a case-by-case basis to determine whether they meet the definition of an upgrade, which may require revenue to be deferred and recognized when the upgrade is delivered. If it is determined that implied post-contract customer support (PCS) is being provided, revenue from the arrangement is deferred and recognized over the implied PCS term. If updates are determined to not meet the definition of an upgrade, revenue is generally recognized as products are shipped or made available.

Microsoft enters into arrangements that can include various combinations of software, services, and hardware. Where elements are delivered over different periods of time, and when allowed under U.S. GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement, and revenue is recognized as each element is delivered. We use a hierarchy to determine the fair value to be used for allocating revenue to elements: (i) vendor-specific objective evidence of fair value (VSOE), (ii) third-party evidence, and (iii) best estimate of selling price (ESP). For software elements, we follow the industry specific software guidance which only allows for the use of VSOE in establishing fair value. Generally, VSOE is the price charged when the deliverable is sold separately or the price established by management for a product that is not yet sold if it is probable that the price will not change before introduction into the marketplace. ESPs are established as best estimates of what the selling prices would be if the deliverables were sold regularly on a stand-alone basis. Our process for determining ESPs requires judgment and considers multiple factors that may vary over time depending upon the unique facts and circumstances related to each deliverable.

Windows 7 revenue was subject to deferral as a result of the Windows Upgrade Offer, which started June 2, 2012. The offer provided significantly discounted rights to purchase Windows 8 Pro to qualifying end-users that purchased Windows 7 PCs during the eligibility period. Microsoft was responsible for delivering Windows 8 Pro to the end customer. Accordingly, revenue related to the allocated discount for undelivered Windows 8 was deferred until it was delivered or the redemption period expired.

Impairment of Investment Securities

We review investments quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed-income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) 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.

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

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

The valuation of acquired assets and liabilities, including goodwill, resulting from the acquisition of NDS, is reflective of the enterprise value based on the long-term financial forecast for the business. In this highly competitive and volatile market, it is possible that we may not realize our forecasts. Given the value assigned to goodwill in the purchase price allocation, we will closely monitor the performance of the business versus the long-term forecast to determine if any impairments arise.

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. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our consolidated financial statements.

Income Taxes

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

Inventories

Inventories are stated at average cost, subject to the lower of cost or market. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory

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quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. These reviews include analysis of demand forecasts, product life cycle status, product development plans, current sales levels, pricing strategy, and component cost trends. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue. The determination of market value and the estimated volume of demand used in the lower of cost or market analysis require significant judgment.

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STATEMENT OF MANAGEMENT S RESPONSIBILITY FOR FINANCIAL STATEMENTS

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

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

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

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

Satya Nadella
Chief Executive Officer

Amy E. Hood
Executive Vice President and Chief Financial Officer

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

Chief Accounting Officer

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Item 7A

ITEM 7A. 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 consolidated 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.

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The following table sets forth the one-day VaR for substantially all of our positions as of June 30, 2014 and 2013 and for the year ended June 30, 2014:

(In millions)

			Year Ended June 30, 2014		
Risk Categories	**June 30, 2014**	**June 30, 2013**	**Average**	**High**	**Low**
Foreign currency	**$ 179**	$ 199	**$ 215**	**$ 287**	**$ 117**
Interest rate	**$ 73**	$ 85	**$ 82**	**$ 91**	**$ 73**
Equity	**$ 176**	$ 181	**$ 208**	**$ 246**	**$ 173**
Commodity	**$ 17**	$ 19	**$ 18**	**$ 21**	**$ 16**

Total one-day VaR for the combined risk categories was $333 million at June 30, 2014 and $350 million at June 30, 2013. The total VaR is 25% less at June 30, 2014, and 28% less at June 30, 2013, than the sum of the separate risk categories in the table above due to the diversification benefit of the combination of risks.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,	**2014**	**2013**	**2012**
Revenue	**$ 86,833**	$ 77,849	$ 73,723
Cost of revenue	**26,934**	20,249	17,530
Gross margin	**59,899**	57,600	56,193
Research and development	**11,381**	10,411	9,811
Sales and marketing	**15,811**	15,276	13,857
General and administrative	**4,821**	5,149	4,569
Goodwill impairment	**0**	0	6,193
Integration and restructuring	**127**	0	0
Operating income	**27,759**	26,764	21,763
Other income, net	**61**	288	504
Income before income taxes	**27,820**	27,052	22,267
Provision for income taxes	**5,746**	5,189	5,289
Net income	**$ 22,074**	$ 21,863	$ 16,978
Earnings per share:			
Basic	**$ 2.66**	$ 2.61	$ 2.02
Diluted	**$ 2.63**	$ 2.58	$ 2.00
Weighted average shares outstanding:			
Basic	**8,299**	8,375	8,396
Diluted	**8,399**	8,470	8,506
Cash dividends declared per common share	**$ 1.12**	$ 0.92	$ 0.80

See accompanying notes.

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COMPREHENSIVE INCOME STATEMENTS

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Net income	**$ 22,074**	$ 21,863	$ 16,978
Other comprehensive income (loss):			
Net unrealized gains (losses) on derivatives (net of tax effects of **$(4)**, $(14), and $137)	**(35)**	(26)	255
Net unrealized gains (losses) on investments (net of tax effects of **$936**, $195, and $(210))	**1,737**	363	(390)
Translation adjustments and other (net of tax effects of **$12**, $(8), and $(165))	**263**	(16)	(306)
Other comprehensive income (loss)	**1,965**	321	(441)
Comprehensive income	**$ 24,039**	$ 22,184	$ 16,537

See accompanying notes.

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BALANCE SHEETS

(In millions)

June 30,	**2014**	**2013**
Assets		
Current assets:		
Cash and cash equivalents	**$ 8,669**	$ 3,804
Short-term investments (including securities loaned of **$541** and $579)	**77,040**	73,218
Total cash, cash equivalents, and short-term investments	**85,709**	77,022
Accounts receivable, net of allowance for doubtful accounts of **$301** and $336	**19,544**	17,486
Inventories	**2,660**	1,938
Deferred income taxes	**1,941**	1,632
Other	**4,392**	3,388
Total current assets	**114,246**	101,466
Property and equipment, net of accumulated depreciation of **$14,793** and $12,513	**13,011**	9,991
Equity and other investments	**14,597**	10,844
Goodwill	**20,127**	14,655
Intangible assets, net	**6,981**	3,083
Other long-term assets	**3,422**	2,392
Total assets	**$ 172,384**	$ 142,431
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	**$ 7,432**	$ 4,828
Short-term debt	**2,000**	0
Current portion of long-term debt	**0**	2,999
Accrued compensation	**4,797**	4,117
Income taxes	**782**	592
Short-term unearned revenue	**23,150**	20,639
Securities lending payable	**558**	645
Other	**6,906**	3,597
Total current liabilities	**45,625**	37,417
Long-term debt	**20,645**	12,601
Long-term unearned revenue	**2,008**	1,760
Deferred income taxes	**2,728**	1,709
Other long-term liabilities	**11,594**	10,000
Total liabilities	**82,600**	63,487

Commitments and contingencies		
Stockholders equity:		
Common stock and paid-in capital shares authorized 24,000; outstanding **8,239** and 8,328	**68,366**	67,306
Retained earnings	**17,710**	9,895
Accumulated other comprehensive income	**3,708**	1,743
Total stockholders equity	**89,784**	78,944
Total liabilities and stockholders equity	**$ 172,384**	$ 142,431

See accompanying notes.

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CASH FLOWS STATEMENTS

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Operations			
Net income	**$ 22,074**	$ 21,863	$ 16,978
Adjustments to reconcile net income to net cash from operations:			
Goodwill impairment	**0**	0	6,193
Depreciation, amortization, and other	**5,212**	3,755	2,967
Stock-based compensation expense	**2,446**	2,406	2,244
Net recognized losses (gains) on investments and derivatives	**(109)**	80	(200)
Excess tax benefits from stock-based compensation	**(271)**	(209)	(93)
Deferred income taxes	**(331)**	(19)	954
Deferral of unearned revenue	**44,325**	44,253	36,104
Recognition of unearned revenue	**(41,739)**	(41,921)	(33,347)
Changes in operating assets and liabilities:			
Accounts receivable	**(1,120)**	(1,807)	(1,156)
Inventories	**(161)**	(802)	184
Other current assets	**(29)**	(129)	493
Other long-term assets	**(628)**	(478)	(248)
Accounts payable	**473**	537	(31)
Other current liabilities	**1,075**	146	410
Other long-term liabilities	**1,014**	1,158	174
Net cash from operations	**32,231**	28,833	31,626
Financing			
Proceeds from issuance of short-term debt, maturities of 90 days or less, net	**500**	0	0
Proceeds from issuance of debt	**10,350**	4,883	0
Repayments of debt	**(3,888)**	(1,346)	0
Common stock issued	**607**	931	1,913
Common stock repurchased	**(7,316)**	(5,360)	(5,029)
Common stock cash dividends paid	**(8,879)**	(7,455)	(6,385)
Excess tax benefits from stock-based compensation	**271**	209	93
Other	**(39)**	(10)	0
Net cash used in financing	**(8,394)**	(8,148)	(9,408)
Investing			
Additions to property and equipment	**(5,485)**	(4,257)	(2,305)
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets	**(5,937)**	(1,584)	(10,112)
Purchases of investments	**(72,690)**	(75,396)	(57,250)
Maturities of investments	**5,272**	5,130	15,575
Sales of investments	**60,094**	52,464	29,700

Securities lending payable	**(87)**	(168)	(394)
Net cash used in investing	**(18,833)**	(23,811)	(24,786)
Effect of exchange rates on cash and cash equivalents	**(139)**	(8)	(104)
Net change in cash and cash equivalents	**4,865**	(3,134)	(2,672)
Cash and cash equivalents, beginning of period	**3,804**	6,938	9,610
Cash and cash equivalents, end of period	**$ 8,669**	$ 3,804	$ 6,938

See accompanying notes.

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STOCKHOLDERS EQUITY STATEMENTS

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Common stock and paid-in capital			
Balance, beginning of period	**$ 67,306**	$ 65,797	$ 63,415
Common stock issued	**607**	920	1,924
Common stock repurchased	**(2,328)**	(2,014)	(1,714)
Stock-based compensation expense	**2,446**	2,406	2,244
Stock-based compensation income tax benefits (deficiencies)	**272**	190	(75)
Other, net	**63**	7	3
Balance, end of period	**68,366**	67,306	65,797
Retained earnings (deficit)			
Balance, beginning of period	**9,895**	(856)	(8,195)
Net income	**22,074**	21,863	16,978
Common stock cash dividends	**(9,271)**	(7,694)	(6,721)
Common stock repurchased	**(4,988)**	(3,418)	(2,918)
Balance, end of period	**17,710**	9,895	(856)
Accumulated other comprehensive income			
Balance, beginning of period	**1,743**	1,422	1,863
Other comprehensive income (loss)	**1,965**	321	(441)
Balance, end of period	**3,708**	1,743	1,422
Total stockholders equity	**$ 89,784**	$ 78,944	$ 66,363

See accompanying notes.

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NOTES TO FINANCIAL STATEMENTS

NOTE 1 ACCOUNTING POLICIES

Accounting Principles

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

Principles of Consolidation

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

Estimates and Assumptions

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

Recasting of Certain Prior Period Information

During the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. As a result, information that our chief operating decision maker regularly reviews for purposes of allocating resources and assessing performance changed. Therefore, beginning in fiscal year 2014, we reported our financial performance based on our new segments described in Note 21 Segment Information and Geographic Data. We have recast certain prior period amounts to conform to the way we internally managed and monitored segment performance during fiscal year 2014. This change impacted Note 10 Goodwill, Note 14 Unearned Revenue, and Note 21 Segment Information and Geographic Data, with no impact on our consolidated financial statements.

Foreign Currencies

Assets and liabilities recorded in foreign currencies are translated at the exchange rate on the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the year. Translation adjustments resulting from this process are recorded to other comprehensive income (OCI).

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is probable. Revenue generally is recognized net of allowances for returns and any taxes collected from customers and

subsequently remitted to governmental authorities.

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Revenue recognition for multiple-element arrangements requires judgment to determine if multiple elements exist, whether elements can be accounted for as separate units of accounting, and if so, the fair value for each of the elements.

Microsoft enters into arrangements that can include various combinations of software, services, and hardware. Where elements are delivered over different periods of time, and when allowed under U.S. GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement, and revenue is recognized as each element is delivered. We use a hierarchy to determine the fair value to be used for allocating revenue to elements: (i) vendor-specific objective evidence of fair value (VSOE), (ii) third-party evidence, and (iii) best estimate of selling price (ESP). For software elements, we follow the industry specific software guidance which only allows for the use of VSOE in establishing fair value. Generally, VSOE is the price charged when the deliverable is sold separately or the price established by management for a product that is not yet sold if it is probable that the price will not change before introduction into the marketplace. ESPs are established as best estimates of what the selling prices would be if the deliverables were sold regularly on a stand-alone basis. Our process for determining ESPs requires judgment and considers multiple factors that may vary over time depending upon the unique facts and circumstances related to each deliverable.

Revenue for retail packaged products, products licensed to original equipment manufacturers (OEMs), and perpetual licenses under certain volume licensing programs generally is recognized as products are shipped or made available.

Technology guarantee programs are accounted for as multiple-element arrangements as customers receive free or significantly discounted rights to use upcoming new versions of a software product if they license existing versions of the product during the eligibility period. Revenue is allocated between the existing product and the new product, and revenue allocated to the new product is deferred until that version is delivered. The revenue allocation is based on the VSOE of fair value of the products. The VSOE of fair value for upcoming new products are based on the price determined by management having the relevant authority when the element is not yet sold separately, but is expected to be sold in the near future at the price set by management.

Software updates that will be provided free of charge are evaluated on a case-by-case basis to determine whether they meet the definition of an upgrade and create a multiple-element arrangement, which may require revenue to be deferred and recognized when the upgrade is delivered, or if it is determined that implied post-contract customer support (PCS) is being provided, the arrangement is accounted for as a multiple-element arrangement and all revenue from the arrangement is deferred and recognized over the implied PCS term when the VSOE of fair value does not exist. If updates are determined to not meet the definition of an upgrade, revenue is generally recognized as products are shipped or made available.

Certain volume licensing arrangements include a perpetual license for current products combined with rights to receive unspecified future versions of software products (Software Assurance), which we have determined are additional software products and are therefore accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period. Arrangements that include term-based licenses for current products with the right to use unspecified future versions of the software during the coverage period, are also accounted for as subscriptions, with revenue recognized ratably over the coverage period.

Revenue from cloud-based services arrangements that allow for the use of a hosted software product or service over a contractually determined period of time without taking possession of software are accounted for as subscriptions with billings recorded as unearned revenue and recognized as revenue ratably over the coverage period beginning on the date the service is made available to customers. Revenue from cloud-based services arrangements that are provided on a consumption basis (for example, the amount of storage used in a particular period) is recognized commensurate with the customer utilization of such resources.

Some volume licensing arrangements include time-based subscriptions for cloud-based services and software offerings that are accounted for as subscriptions. These arrangements are considered multiple-element arrangements. However, because all elements are accounted for as subscriptions and have the same coverage period and delivery pattern, they have the same revenue recognition timing.

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Revenue related to phones, Surface, Xbox consoles, games published by us, and other hardware components is generally recognized when ownership is transferred to the resellers or to end customers when selling directly through Microsoft retail stores and online marketplaces. A portion of revenue may be deferred when these products are combined with software elements, and/or services. Revenue related to licensing for games published by third parties for use on the Xbox consoles is recognized when games are manufactured by the game publishers.

Display advertising revenue is recognized as advertisements are displayed. Search advertising revenue is recognized when the ad appears in the search results or when the action necessary to earn the revenue has been completed. Consulting services revenue is recognized as services are rendered, generally based on the negotiated hourly rate in the consulting arrangement and the number of hours worked during the period. Consulting revenue for fixed-price services arrangements is recognized as services are provided. Revenue from prepaid points redeemable for the purchase of software or services is recognized upon redemption of the points and delivery of the software or services.

Cost of Revenue

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

Product Warranty

We provide for the estimated costs of fulfilling our obligations under hardware and software warranties at the time the related revenue is recognized. For hardware warranties, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and the country in which we do business, but generally include parts and labor over a period generally ranging from 90 days to three years. For software warranties, we estimate the costs to provide bug fixes, such as security patches, over the estimated life of the software. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Research and Development

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. Such costs related to software development are included in research and development expense until the point that technological feasibility is reached, which for our software products, is generally shortly before the products are released to manufacturing. Once technological feasibility is reached, such costs are capitalized and amortized to cost of revenue over the estimated lives of the products.

Sales and Marketing

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel, and the costs of advertising, promotions, trade shows, seminars, and other programs. Advertising costs are expensed as incurred. Advertising expense was $2.3 billion, $2.6 billion, and $1.6 billion in fiscal years 2014, 2013, and 2012, respectively.

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Stock-Based Compensation

We measure stock-based compensation cost at the grant date based on the fair value of the award and recognize it as expense, net of estimated forfeitures, over the vesting or service period, as applicable, of the stock award (generally four to five years) using the straight-line method.

Employee Stock Purchase Plan

Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value of the stock on the last day of each three-month period. Compensation expense for the employee stock purchase plan is measured as the discount the employee is entitled to upon purchase and is recognized in the period of purchase.

Income Taxes

Income tax expense includes U.S. and international income taxes, the provision for U.S. taxes on undistributed earnings of international subsidiaries not deemed to be permanently invested, and interest and penalties on uncertain tax positions. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. Deferred tax assets are reported net of a valuation allowance when it is more likely than not that a tax benefit will not be realized. The deferred income taxes are classified as current or long-term based on the classification of the related asset or liability.

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. government securities, 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, credit spreads, 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, common and preferred stock, mortgage-backed securities, certificates of deposit, and foreign government bonds. 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 common and preferred stock and goodwill when it is recorded at fair value due to an impairment charge. Unobservable inputs used in the models are significant to the fair values of the assets and liabilities.

We measure certain assets, including our cost and equity method investments, at fair value on a nonrecurring basis when they are deemed to be other-than-temporarily impaired. The fair values of these investments are determined

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based on valuation techniques using the best information available, and may include quoted market prices, market comparables, and discounted cash flow projections. An impairment charge is recorded when the cost of the investment exceeds its fair value and this condition is determined to be other-than-temporary.

Our other current financial assets and our current financial liabilities have fair values that approximate their carrying values.

Financial Instruments

We consider all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. The fair values of these investments approximate their carrying values. In general, investments with original maturities of greater than three months and remaining maturities of less than one year are classified as short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash equivalents and short-term investments are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in market value, excluding other-than-temporary impairments, are reflected in OCI.

Equity and other investments classified as long-term include both debt and equity instruments. With the exception of certain corporate notes that are classified as held-to-maturity, debt and publicly-traded equity securities are classified as available-for-sale and realized gains and losses are recorded using the specific identification method. Changes in the market value of available-for-sale securities, excluding other-than-temporary impairments, are reflected in OCI. Held-to-maturity investments are recorded and held at amortized cost. Common and preferred stock and other investments that are restricted for more than one year or are not publicly traded are recorded at cost or using the equity method.

We lend certain fixed-income and equity securities to increase investment returns. 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.

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. Fair value is calculated based on publicly available market information or other estimates determined by management. We employ a systematic methodology on a quarterly basis that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our intent and ability to hold, or plans to sell, the investment. For fixed-income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established.

Derivative instruments are recognized as either assets or liabilities and are measured at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

For derivative instruments designated as fair value hedges, the gains (losses) are recognized in earnings in the periods of change together with the offsetting losses (gains) on the hedged items attributed to the risk being hedged. For options designated as fair value hedges, changes in the time value are excluded from the assessment of hedge effectiveness and are recognized in earnings.

For derivative instruments designated as cash-flow hedges, the effective portion of the gains (losses) on the derivatives is initially reported as a component of OCI and is subsequently recognized in earnings when the hedged

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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 reclassified from accumulated other comprehensive income (AOCI) into other income (expense).

Allowance for Doubtful Accounts

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

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Balance, beginning of period	**$ 336**	$ 389	$ 333
Charged to costs and other	**16**	4	115
Write-offs	**(51)**	(57)	(59)
Balance, end of period	**$ 301**	$ 336	$ 389

Inventories

Inventories are stated at average cost, subject to the lower of cost or market. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis through a charge to cost of revenue. The determination of market value and the estimated volume of demand used in the lower of cost or market analysis require significant judgment.

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the lease term. The estimated useful lives of our property and equipment are generally as follows: computer software developed or acquired for internal use, three to seven years; computer equipment, two to three years; buildings and improvements, five to 15 years; leasehold improvements, two to 20 years; and furniture and equipment, one to 10 years. Land is not depreciated.

Goodwill

Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a

reporting unit below its carrying value.

Intangible Assets

All of our intangible assets are subject to amortization and are amortized using the straight-line method over their estimated period of benefit, ranging from one to 15 years. We evaluate the recoverability of intangible assets periodically by taking into account events or circumstances that may warrant revised estimates of useful lives or that indicate the asset may be impaired.

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Recent Accounting Guidance

Recently adopted accounting guidance

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance enhancing disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial 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. In January 2013, the FASB clarified that the scope of this guidance applies to derivatives, repurchase agreements, and securities lending arrangements that are either offset or subject to an enforceable master netting arrangement, or similar agreements. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 5 Derivatives.

In February 2013, the FASB issued guidance on disclosure requirements for items reclassified out of AOCI. This new guidance requires entities to present (either on the face of the income statement or in the notes to financial statements) the effects on the line items of the income statement for amounts reclassified out of AOCI. We adopted this new guidance beginning July 1, 2013. Adoption of this new guidance resulted only in changes to the presentation of Note 19 Accumulated Other Comprehensive Income.

Recent accounting guidance not yet adopted

In March 2013, the FASB issued guidance on a parent s accounting for the cumulative translation adjustment upon derecognition of a subsidiary or group of assets within a foreign entity. This new guidance requires that the parent release any related cumulative translation adjustment into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The new guidance will be effective for us beginning July 1, 2014. We do not anticipate material impacts on our consolidated financial statements upon adoption.

In May 2014, as part of its ongoing efforts to assist in the convergence of U.S. GAAP and International Financial Reporting Standards, the FASB issued a new standard related to revenue recognition. Under the new standard, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The new standard will be effective for us beginning July 1, 2017 and early adoption is not permitted. We anticipate this standard will have a material impact, and we are currently evaluating the impact this standard will have on our consolidated financial statements.

NOTE 2 EARNINGS PER SHARE

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

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The components of basic and diluted EPS are as follows:

(In millions, except earnings per share)

Year Ended June 30,	**2014**	**2013**	**2012**
Net income available for common shareholders (A)	**$ 22,074**	$ 21,863	$ 16,978
Weighted average outstanding shares of common stock (B)	**8,299**	8,375	8,396
Dilutive effect of stock-based awards	**100**	95	110
Common stock and common stock equivalents (C)	**8,399**	8,470	8,506
Earnings Per Share			
Basic (A/B)	**$ 2.66**	$ 2.61	$ 2.02
Diluted (A/C)	**$ 2.63**	$ 2.58	$ 2.00

Anti-dilutive stock-based awards excluded from the calculations of diluted EPS were immaterial during the periods presented.

NOTE 3 OTHER INCOME (EXPENSE)

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

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Dividends and interest income	**$ 883**	$ 677	$ 800
Interest expense	**(597)**	(429)	(380)
Net recognized gains on investments	**437**	116	564
Net losses on derivatives	**(328)**	(196)	(364)
Net losses on foreign currency remeasurements	**(165)**	(74)	(117)
Other	**(169)**	194	1
Total	**$ 61**	$ 288	$ 504

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

(In millions)

Year Ended June 30,	2014	2013	2012
Other-than-temporary impairments of investments	**$ (106)**	$ (208)	$ (298)
Realized gains from sales of available-for-sale securities	**776**	489	1,418
Realized losses from sales of available-for-sale securities	**(233)**	(165)	(556)
Total	**$ 437**	$ 116	$ 564

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NOTE 4 INVESTMENTS

Investment Components

The components of investments, including associated derivatives, but excluding held-to-maturity investments, were as follows:

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2014							
Cash	**$ 4,980**	**$ 0**	**$ 0**	**$ 4,980**	**$ 4,980**	**$ 0**	**$ 0**
Mutual funds	**590**	**0**	**0**	**590**	**590**	**0**	**0**
Commercial paper	**189**	**0**	**0**	**189**	**89**	**100**	**0**
Certificates of deposit	**1,197**	**0**	**0**	**1,197**	**865**	**332**	**0**
U.S. government and agency securities	**66,952**	**103**	**(29)**	**67,026**	**109**	**66,917**	**0**
Foreign government bonds	**3,328**	**17**	**(10)**	**3,335**	**2,027**	**1,308**	**0**
Mortgage-backed securities	**991**	**30**	**(2)**	**1,019**	**0**	**1,019**	**0**
Corporate notes and bonds	**6,845**	**191**	**(9)**	**7,027**	**9**	**7,018**	**0**
Municipal securities	**287**	**45**	**0**	**332**	**0**	**332**	**0**
Common and preferred stock	**6,785**	**5,207**	**(81)**	**11,911**	**0**	**0**	**11,911**
Other investments	**1,164**	**0**	**0**	**1,164**	**0**	**14**	**1,150**
Total	**$ 93,308**	**$ 5,593**	**$ (131)**	**$ 98,770**	**$ 8,669**	**$ 77,040**	**$ 13,061**

(In millions)	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis	Cash and Cash Equivalents	Short-term Investments	Equity and Other Investments
June 30, 2013							
Cash	$ 1,967	$ 0	$ 0	$ 1,967	$ 1,967	$ 0	$ 0
Mutual funds	868	0	0	868	868	0	0
Commercial paper	603	0	0	603	214	389	0
Certificates of deposit	994	0	0	994	609	385	0
U.S. government and agency securities	64,934	47	(84)	64,897	146	64,751	0

Foreign government bonds	900	16	(41)	875	0	875	0
Mortgage-backed securities	1,258	43	(13)	1,288	0	1,288	0
Corporate notes and bonds	4,993	169	(40)	5,122	0	5,122	0
Municipal securities	350	36	(1)	385	0	385	0
Common and preferred stock	6,931	2,938	(281)	9,588	0	0	9,588
Other investments	1,279	0	0	1,279	0	23	1,256
Total	$ 85,077	$ 3,249	$ (460)	$ 87,866	$ 3,804	$ 73,218	$ 10,844

In addition to the investments in the table above, we also own corporate notes that were purchased in connection with our agreement to lend $2.0 billion to the group that completed their acquisition of Dell on October 29, 2013. These corporate notes are classified as held-to-maturity investments and are included in equity and other investments on the balance sheet. As of June 30, 2014, the amortized cost, recorded basis, and estimated fair value of these corporate notes was $1.5 billion, $1.5 billion, and $1.7 billion, respectively, while their associated gross unrecognized holding gains were $164 million.

As of June 30, 2014 and 2013, the recorded bases of common and preferred stock that are restricted for more than one year or are not publicly traded were $520 million and $395 million, respectively. These investments are carried at cost and are reviewed quarterly for indicators of other-than-temporary impairment. It is not practicable for us to reliably estimate the fair value of these investments.

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Unrealized Losses on Investments

Investments, excluding those held-to-maturity, with continuous unrealized losses for less than 12 months and 12 months or greater and their related fair values were as follows:

(In millions)	Less than 12 Months		12 Months or Greater			
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2014						
U.S. government and agency securities	**$ 4,161**	**$ (29)**	**$ 850**	**$ 0**	**$ 5,011**	**$ (29)**
Foreign government bonds	**566**	**(4)**	**21**	**(6)**	**587**	**(10)**
Mortgage-backed securities	**120**	**0**	**61**	**(2)**	**181**	**(2)**
Corporate notes and bonds	**1,154**	**(8)**	**34**	**(1)**	**1,188**	**(9)**
Common and preferred stock	**463**	**(48)**	**257**	**(33)**	**720**	**(81)**
Total	**$ 6,464**	**$ (89)**	**$ 1,223**	**$ (42)**	**$ 7,687**	**$ (131)**

(In millions)	Less than 12 Months		12 Months or Greater			
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2013						
U.S. government and agency securities	$ 2,208	$ (84)	$ 0	$ 0	$ 2,208	$ (84)
Foreign government bonds	589	(18)	69	(23)	658	(41)
Mortgage-backed securities	357	(12)	39	(1)	396	(13)
Corporate notes and bonds	1,142	(38)	27	(2)	1,169	(40)
Municipal securities	44	(1)	0	0	44	(1)
Common and preferred stock	1,166	(168)	409	(113)	1,575	(281)
Total	$ 5,506	$ (321)	$ 544	$ (139)	$ 6,050	$ (460)

As of June 30, 2014, we did not hold any held-to-maturity investments that are in an unrealized loss position.

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 June 30, 2014.

Debt Investment Maturities

(In millions)	Cost Basis	Estimated Fair Value
June 30, 2014		
Due in one year or less	$ 28,681	$ 28,719
Due after one year through five years	46,734	46,881
Due after five years through 10 years	2,910	2,987
Due after 10 years	1,464	1,538
Total [(a)]	$ 79,789	$ 80,125

(a) *Excludes held-to-maturity investments due October 31, 2023 with a cost basis and estimated fair value at June 30, 2014 of $1.5 billion and $1.7 billion, respectively.*

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NOTE 5 DERIVATIVES

We use derivative instruments to manage risks related to foreign currencies, equity prices, interest rates, and credit; to enhance investment returns; and to facilitate portfolio diversification. Our objectives for holding derivatives include reducing, eliminating, and efficiently managing the economic impact of these exposures as effectively as possible. Our derivative programs include strategies that both qualify and do not qualify for hedge accounting treatment. All notional amounts presented below are measured in U.S. dollar equivalents.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily to maximize the economic effectiveness of our foreign currency hedge positions. Option and forward contracts are used to hedge a portion of forecasted international revenue for up to three years in the future and are designated as cash flow hedging instruments. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar. As of June 30, 2014 and June 30, 2013, the total notional amounts of these foreign exchange contracts sold were $4.9 billion and $5.1 billion, respectively.

Foreign currency risks related to certain non-U.S. dollar denominated securities are hedged using foreign exchange forward contracts that are designated as fair value hedging instruments. As of June 30, 2014 and June 30, 2013, the total notional amounts of these foreign exchange contracts sold were $3.1 billion and $407 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 June 30, 2014, the total notional amounts of these foreign exchange contracts purchased and sold were $6.2 billion and $8.5 billion, respectively. As of June 30, 2013, the total notional amounts of these foreign exchange contracts purchased and sold were $5.0 billion and $7.9 billion, respectively.

Equity

Securities held in our equity and other investments portfolio are subject to market price risk. Market price risk is managed relative to broad-based global and domestic equity indices using certain convertible preferred investments, options, futures, and swap contracts not designated as hedging instruments. From time to time, to hedge our price risk, we may use and designate equity derivatives as hedging instruments, including puts, calls, swaps, and forwards. As of June 30, 2014, the total notional amounts of equity contracts purchased and sold for managing market price risk were $3.1 billion and $2.1 billion, respectively, of which $362 million and $420 million, respectively, were designated as hedging instruments. As of June 30, 2013, the total notional amounts of equity contracts purchased and sold for managing market price risk were $898 million and $1.0 billion, respectively, none of which were designated as hedging instruments.

Interest Rate

Securities held in our fixed-income portfolio are subject to different interest rate risks based on their maturities. We manage the average maturity of our fixed-income portfolio to achieve economic returns that correlate to certain broad-based fixed-income indices using exchange-traded option and futures contracts and over-the-counter swap and option contracts, none of which are designated as hedging instruments. As of June 30, 2014, the total notional amounts of fixed-interest rate contracts purchased and sold were $503 million and $741 million, respectively. As of June 30, 2013, the total notional amounts of fixed-interest rate contracts purchased and sold were $1.1 billion and $809 million, respectively.

In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency mortgage-backed securities. These meet the definition of a derivative instrument in cases where physical delivery of the assets is not taken at the earliest available delivery date. As of June 30, 2014 and 2013, the total notional derivative amounts of mortgage contracts purchased were $1.1 billion and $1.2 billion, respectively.

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Credit

Our fixed-income portfolio is diversified and consists primarily of investment-grade securities. We use credit default swap contracts, not designated as hedging instruments, to manage credit exposures relative to broad-based indices and to facilitate portfolio diversification. We use credit default swaps as they are a low cost method of managing exposure to individual credit risks or groups of credit risks. As of June 30, 2014, the total notional amounts of credit contracts purchased and sold were $412 million and $440 million, respectively. As of June 30, 2013, the total notional amounts of credit contracts purchased and sold were $377 million and $501 million, respectively.

Commodity

We use broad-based commodity exposures to enhance portfolio returns and to facilitate portfolio diversification. We use swaps, 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 June 30, 2014, the total notional amounts of commodity contracts purchased and sold were $1.4 billion and $408 million, respectively. As of June 30, 2013, the total notional amounts of commodity contracts purchased and sold were $1.2 billion and $249 million, respectively.

Credit-Risk-Related Contingent Features

Certain of our counterparty agreements for derivative instruments contain provisions that require our issued and outstanding long-term unsecured debt to maintain an investment grade credit rating and require us to maintain minimum liquidity of $1.0 billion. To the extent we fail to meet these requirements, we will be required to post collateral, similar to the standard convention related to over-the-counter derivatives. As of June 30, 2014, 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.

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Fair Values of Derivative Instruments

The following tables present the fair values of derivative instruments designated as hedging instruments (designated hedge derivatives) and not designated as hedging instruments (non-designated hedge derivatives). The fair values exclude the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists and fair value adjustments related to our own credit risk and counterparty credit risk:

	June 30, 2014				June 30, 2013		
	Assets			Liabilities	Assets		Liabilities
(In millions)	**Short-term Investments**	**Other Current Assets**	**Equity and Other Investments**	**Other Current Liabilities**	**Short-term Investments**	**Other Current Assets**	**Other Current Liabilities**
Non-designated Hedge Derivatives							
Foreign exchange contracts	**$ 10**	**$ 39**	**$ 0**	**$ (97)**	$ 41	$ 87	$ (63)
Equity contracts	**177**	**0**	**0**	**(21)**	157	0	(9)
Interest rate contracts	**17**	**0**	**0**	**(12)**	18	0	(45)
Credit contracts	**24**	**0**	**0**	**(13)**	19	0	(17)
Commodity contracts	**15**	**0**	**0**	**(1)**	3	0	(1)
Total	**$ 243**	**$ 39**	**$ 0**	**$ (144)**	$ 238	$ 87	$ (135)
Designated Hedge Derivatives							
Foreign exchange contracts	**$ 1**	**$ 70**	**$ 0**	**$ (15)**	$ 9	$ 167	$ 0
Equity contracts	**0**	**0**	**7**	**(125)**	0	0	0
Total	**$ 1**	**$ 70**	**$ 7**	**$ (140)**	$ 9	$ 167	$ 0
Total gross amounts of derivatives	**$ 244**	**$ 109**	**$ 7**	**$ (284)**	$ 247	$ 254	$ (135)
Gross derivatives either offset or subject to an enforceable master netting agreement	**$ 99**	**$ 109**	**$ 7**	**$ (284)**	$ 105	$ 254	$ (97)
Gross amounts offset in the balance sheet	**(77)**	**(71)**	**(7)**	**155**	(72)	(9)	80
Net amounts presented in the balance sheet	**$ 22**	**$ 38**	**$ 0**	**$ (129)**	$ 33	$ 245	$ (17)
Gross amounts not offset in the balance sheet	**0**	**0**	**0**	**0**	0	0	0
Net amount	**$ 22**	**$ 38**	**$ 0**	**$ (129)**	$ 33	$ 245	$ (17)

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

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Fair Value Hedge Gains (Losses)

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

(In millions)

Year Ended June 30,	**2014**	2013	2012
Foreign Exchange Contracts			
Derivatives	**$ (14)**	$ 70	$ 52
Hedged items	**6**	(69)	(50)
Total amount of ineffectiveness	**$ (8)**	$ 1	$ 2
Equity Contracts			
Derivatives	**$ (110)**	$ 0	$ 0
Hedged items	**110**	0	0
Total amount of ineffectiveness	**$ 0**	$ 0	$ 0
Amount of equity contracts excluded from effectiveness assessment	**$ (9)**	$ 0	$ 0

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)

Year Ended June 30,	**2014**	2013	2012
Effective Portion			
Gains recognized in OCI, net of tax effects of **$2**, $54 and $127	**$ 63**	$ 101	$ 236
Gains (losses) reclassified from AOCI into revenue	**$ 104**	$ 195	$ (27)
Amount Excluded from Effectiveness Assessment and Ineffective Portion			
Losses recognized in other income (expense)	**$ (239)**	$ (168)	$ (231)

We estimate that $32 million of net derivative gains included in AOCI at June 30, 2014 will be reclassified into earnings within the following 12 months. No significant amounts of gains (losses) were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during fiscal year 2014.

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)

Year Ended June 30,	2014	2013	2012
Foreign exchange contracts	**$ (78)**	$ 18	$ (119)
Equity contracts	**(64)**	16	(85)
Interest-rate contracts	**24**	(11)	93
Credit contracts	**13**	(3)	(7)
Commodity contracts	**71**	(42)	(121)
Total	**$ (34)**	$ (22)	$ (239)

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NOTE 6 FAIR VALUE MEASUREMENTS

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2014						
Assets						
Mutual funds	**$ 590**	**$ 0**	**$ 0**	**$ 590**	**$ 0**	**$ 590**
Commercial paper	**0**	**189**	**0**	**189**	**0**	**189**
Certificates of deposit	**0**	**1,197**	**0**	**1,197**	**0**	**1,197**
U.S. government and agency securities	**66,288**	**745**	**0**	**67,033**	**0**	**67,033**
Foreign government bonds	**139**	**3,210**	**0**	**3,349**	**0**	**3,349**
Mortgage-backed securities	**0**	**1,015**	**0**	**1,015**	**0**	**1,015**
Corporate notes and bonds	**0**	**6,863**	**0**	**6,863**	**0**	**6,863**
Municipal securities	**0**	**332**	**0**	**332**	**0**	**332**
Common and preferred stock	**9,552**	**1,825**	**14**	**11,391**	**0**	**11,391**
Derivatives	**5**	**348**	**7**	**360**	**(155)**	**205**
Total	**$ 76,574**	**$ 15,724**	**$ 21**	**$ 92,319**	**$ (155)**	**$ 92,164**
Liabilities						
Derivatives and other	**$ 5**	**$ 153**	**$ 126**	**$ 284**	**$ (155)**	**$ 129**

(In millions)	Level 1	Level 2	Level 3	Gross Fair Value	Netting [(a)]	Net Fair Value
June 30, 2013						
Assets						
Mutual funds	$ 868	$ 0	$ 0	$ 868	$ 0	$ 868
Commercial paper	0	603	0	603	0	603
Certificates of deposit	0	994	0	994	0	994

U.S. government and agency securities	62,237	2,664	0	64,901	0	64,901
Foreign government bonds	9	851	0	860	0	860
Mortgage-backed securities	0	1,311	0	1,311	0	1,311
Corporate notes and bonds	0	4,915	19	4,934	0	4,934
Municipal securities	0	385	0	385	0	385
Common and preferred stock	8,470	717	5	9,192	0	9,192
Derivatives	12	489	0	501	(81)	420
Total	$ 71,596	$ 12,929	$ 24	$ 84,549	$ (81)	$ 84,468
Liabilities						
Derivatives and other	$ 14	$ 121	$ 0	$ 135	$ (80)	$ 55

(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.*

In connection with the transaction to acquire substantially all of Nokia Corporation s (Nokia) Devices and Services Business (NDS), on September 23, 2013 we provided Nokia 1.5 billion ($2.1 billion) principal of convertible notes classified as Level 3 financial instruments. Upon closing of the acquisition, Nokia repurchased these notes at their principal amount plus accrued interest. All other changes in our Level 3 financial instruments that are measured at fair value on a recurring basis were immaterial during the periods presented.

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The following table reconciles the total Net Fair Value of assets above to the balance sheet presentation of these same assets in Note 4 Investments.

(In millions)

June 30,	**2014**	**2013**
Net fair value of assets measured at fair value on a recurring basis	**$ 92,164**	$ 84,468
Cash	**4,980**	1,967
Common and preferred stock measured at fair value on a nonrecurring basis	**520**	395
Other investments measured at fair value on a nonrecurring basis	**1,150**	1,256
Less derivative net assets classified as other current assets	**(38)**	(213)
Other	**(6)**	(7)
Recorded basis of investment components [(a)]	**$ 98,770**	$ 87,866

(a) *Excludes held-to-maturity investments recorded at amortized cost and measured at fair value on a nonrecurring basis.*

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

During fiscal year 2014 and 2013, we did not record any material other-than-temporary impairments on financial assets required to be measured at fair value on a nonrecurring basis.

NOTE 7 INVENTORIES

The components of inventories were as follows:

(In millions)

June 30,	**2014**	**2013**
Raw materials	**$ 944**	$ 328
Work in process	**266**	201
Finished goods	**1,450**	1,409
Total	**$ 2,660**	$ 1,938

NOTE 8 PROPERTY AND EQUIPMENT

The components of property and equipment were as follows:

(In millions)

June 30,	**2014**	2013
Land	**$ 541**	$ 525
Buildings and improvements	**8,867**	7,326
Leasehold improvements	**3,560**	2,946
Computer equipment and software	**11,430**	9,242
Furniture and equipment	**3,406**	2,465
Total, at cost	**27,804**	22,504
Accumulated depreciation	**(14,793)**	(12,513)
Total, net	**$ 13,011**	$ 9,991

During fiscal years 2014, 2013, and 2012, depreciation expense was $3.4 billion, $2.6 billion, and $2.2 billion, respectively.

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NOTE 9 BUSINESS COMBINATIONS

Nokia s Devices and Services Business

On April 25, 2014, we completed the transaction to acquire substantially all of NDS for a total purchase price of $9.5 billion, including cash acquired of $1.5 billion (the Acquisition). The purchase price consisted primarily of cash of $7.1 billion and Nokia s repurchase of convertible notes of $2.1 billion which was a non-cash transaction. The Acquisition is expected to accelerate the growth of our Devices and Consumer (D&C) business through faster innovation, synergies, and unified branding and marketing.

The purchase price allocation as of the date of the Acquisition was based on a preliminary valuation and is subject to revision as more detailed analyses are completed and additional information about the fair value of assets acquired and liabilities assumed become available.

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

(In millions)	
Cash	$ 1,503
Accounts receivable [a]	754
Inventories	544
Other current assets	960
Property and equipment	981
Intangible assets	4,509
Goodwill [b]	5,458
Other	249
Current liabilities	(4,576)
Long-term liabilities	(917)
Total purchase price	$ 9,465

(a) *Gross accounts receivable is $901 million, of which $147 million is expected to be uncollectible.*

(b) Goodwill was assigned to our new Phone Hardware segment. The goodwill was primarily attributed to increased synergies that are expected to be achieved from the integration of NDS. Goodwill of $4.5 billion is expected to be deductible in Finland for tax purposes.

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

(In millions)	Amount	Weighted Average Life
Technology-based	$ 2,493	9 years

Contract-based	1,500	9 years
Customer-related	359	3 years
Marketing-related (trade names)	157	2 years
Fair value of intangible assets acquired	$ 4,509	8 years

Our consolidated income statement for fiscal year 2014 includes revenue and operating loss of $2.0 billion and $692 million, respectively, attributable to NDS since the Acquisition.

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Following are the supplemental consolidated results of Microsoft Corporation on an unaudited pro forma basis, as if the Acquisition had been consummated on July 1, 2012:

(In millions, except per share amounts)

Year Ended June 30,	**2014**	**2013**
Revenue	**$ 96,248**	$ 93,243
Net income	**$ 20,234**	$ 20,153
Diluted earnings per share	**$ 2.41**	$ 2.38

These pro forma results were based on estimates and assumptions, which we believe are reasonable. They are not the results that would have been realized had we been a combined company during the periods presented and are not necessarily indicative of our consolidated results of operations in future periods. The pro forma results include adjustments primarily related to purchase accounting adjustments and the elimination of related party transactions between Microsoft and NDS. Acquisition costs and other non-recurring charges incurred are included in the earliest period presented.

During the fourth quarter of fiscal year 2014, we incurred $21 million of acquisition costs associated with the purchase of NDS. Acquisition costs are primarily comprised of transaction fees and direct acquisition costs, including legal, finance, consulting, and other professional fees. These costs are included in Integration and restructuring costs on our consolidated income statement for fiscal year 2014.

Certain concurrent transactions were recognized separately from the Acquisition. Prior to the Acquisition, we had joint strategic initiatives with Nokia; this contractual relationship was terminated in conjunction with the Acquisition. No gain or loss was recorded upon termination of this agreement, as it was determined to be at market value. In addition, we agreed to license Nokia s mapping services and will pay Nokia separately for the services provided under a four-year license as they are rendered.

Yammer

On July 18, 2012, we acquired Yammer, Inc. (Yammer), a leading provider of enterprise social networks, for $1.1 billion in cash. Yammer will continue to develop its standalone service and will add an enterprise social networking service to Microsoft s portfolio of complementary cloud-based services. The major classes of assets to which we allocated the purchase price were goodwill of $937 million and identifiable intangible assets of $178 million. We assigned the goodwill to Commercial Other under our current segment structure. Yammer was consolidated into our results of operations starting on the acquisition date.

Skype

On October 13, 2011, we acquired 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. The major classes of assets and liabilities to which we allocated the purchase price were goodwill of $7.1 billion, identifiable intangible assets of $1.6 billion, 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 assigned the goodwill to the following segments under our current segment structure: $5.6 billion to Commercial Licensing, $1.4 billion to Computing and Gaming Hardware, and $54 million to D&C Other. Skype was consolidated into our results of operations starting on the acquisition date.

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

(In millions)		Weighted Average Life
Marketing-related (trade names)	$ 1,249	15 years
Technology-based	275	5 years
Customer-related	114	5 years
Contract-based	10	4 years
Total	$ 1,648	13 years

Other

During fiscal year 2014, we completed five additional acquisitions for total consideration of $140 million, all of which was paid in cash. These entities have been included in our consolidated results of operations since their respective acquisition dates.

With the exception of NDS, 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 10 GOODWILL

Changes in the carrying amount of goodwill were as follows:

(In millions)		June 30, 2012	Acquisitions	Other	June 30, 2013	**Acquisitions**	**Other**	**June 30, 2014**
Devices and Consumer	Licensing	$ 866	$ 0	$ 0	$ 866	**$ 0**	**$ 2**	**$ 868**
	Hardware:							
	Computing and Gaming Hardware	1,641	75	(27)	1,689	**0**	**9**	**1,698**
	Phone Hardware	0	0	0	0	**5,458** [a]	**(104)**	**5,354**
	Total D&C Hardware	1,641	75	(27)	1,689	**5,458**	**(95)**	**7,052**
	Other	742	0	(4)	738	**0**	**0**	**738**
	Total Devices and Consumer	3,249	75	(31)	3,293	**5,458**	**(93)**	**8,658**
Commercial	Licensing	10,054	4	(7)	10,051	**2**	**5**	**10,058**

Other	149	1,164	(2)	1,311	**105**	**(5)**	**1,411**
Total Commercial	10,203	1,168	(9)	11,362	**107**	**0**	**11,469**
Total goodwill	$ 13,452	$ 1,243	$ (40)	$ 14,655	**$ 5,565**	**$ (93)**	**$ 20,127**

(a) *Goodwill acquired during fiscal year 2014 related to the acquisition of NDS. See Note 9 Business Combinations for additional details.*
The measurement periods for the valuation of assets acquired and liabilities assumed end as soon as information on the facts and circumstances that existed as of the acquisition dates becomes available, but do not exceed 12 months. Adjustments in purchase price allocations may require a recasting of the amounts allocated to goodwill retroactive to the periods in which the acquisitions occurred.

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Any change in the goodwill amounts resulting from foreign currency translations are presented as Other in the above table. Also included in Other are business dispositions and transfers between business segments due to reorganizations, as applicable.

As discussed in Note 21 Segment Information and Geographic Data, during the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. This resulted in a change in our operating segments and reporting units. We allocated goodwill to our new reporting units using a relative fair value approach. In addition, we completed an assessment of any potential goodwill impairment for all reporting units immediately prior to the reallocation and determined that no impairment existed.

Goodwill Impairment

We test goodwill for impairment annually on May 1 at the reporting unit level using a discounted cash flow methodology with a peer-based, risk-adjusted weighted average cost of capital. We believe use of a discounted cash flow approach is the most reliable indicator of the fair values of the businesses.

No impairment of goodwill was identified as of May 1, 2014 or May 1, 2013. Upon completion of the fiscal year 2012 test, the goodwill of our OSD unit (in Devices and Consumer Other under our current segment structure) was determined to be impaired. The impairment was the result of the OSD unit experiencing slower than projected growth in search queries and search advertising revenue per query, slower growth in display revenue, and changes in the timing and implementation of certain initiatives designed to drive search and display revenue growth in the future. This goodwill impairment charge of $6.2 billion also represented our accumulated goodwill impairment as of June 30, 2014 and 2013.

NOTE 11 INTANGIBLE ASSETS

The components of intangible assets, all of which are finite-lived, were as follows:

(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Year Ended June 30,			**2014**			**2013**
Technology-based [a]	**$ 6,440**	**$ (2,615)**	**$ 3,825**	$ 3,760	$ (2,110)	$ 1,650
Marketing-related	**1,518**	**(324)**	**1,194**	1,348	(211)	1,137
Contract-based	**2,266**	**(716)**	**1,550**	823	(688)	135
Customer-related	**732**	**(320)**	**412**	380	(219)	161
Total	**$ 10,956**	**$ (3,975)**	**$ 6,981**	$ 6,311	$ (3,228)	$ 3,083

(a) *Technology-based intangible assets included $98 million and $218 million as of June 30, 2014 and 2013, respectively, of net carrying amount of software to be sold, leased, or otherwise marketed.*

We estimate that we have no significant residual value related to our intangible assets. No material impairments of intangible assets were identified during any of the periods presented.

The components of intangible assets acquired during the periods presented were as follows:

(In millions)	Amount	Weighted Average Life	Amount	Weighted Average Life
Year Ended June 30,	**2014**		**2013**	
Technology-based	**$ 2,841**	**9 years**	$ 539	4 years
Marketing-related	**174**	**2 years**	39	7 years
Contract-based	**1,500**	**9 years**	0	*
Customer-related	**363**	**3 years**	89	6 years
Total	**$ 4,878**	**8 years**	$ 667	5 years

* *Not applicable*

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The table above includes $4.5 billion related to the acquisition of NDS during fiscal year 2014. See Note 9 Business Combination for additional details.

Intangible assets amortization expense was $845 million, $739 million, and $558 million for fiscal years 2014, 2013, and 2012, respectively. Amortization of capitalized software was $200 million, $210 million, and $117 million for fiscal years 2014, 2013, and 2012, respectively.

The following table outlines the estimated future amortization expense related to intangible assets held at June 30, 2014:

(In millions)	
Year Ending June 30,	
2015	$ 1,237
2016	1,075
2017	804
2018	661
2019	637
Thereafter	2,567
Total	$ 6,981

NOTE 12 DEBT

As of June 30, 2014, we had $22.6 billion of issued and outstanding debt, comprising $2.0 billion of short-term debt and $20.6 billion of long-term debt. As of June 30, 2013, we had $15.6 billion of issued and outstanding long-term debt.

Short-term Debt

As of June 30, 2014, we had $2.0 billion of commercial paper issued and outstanding, with a weighted-average interest rate of 0.12% and maturities ranging from 86 days to 91 days. The estimated fair value of this commercial paper approximates its carrying value.

We have a $5.0 billion credit facility that expires on November 14, 2018, which serves as a back-up for our commercial paper program. As of June 30, 2014, we were in compliance with the only financial covenant in the credit agreement, which requires us to maintain a coverage ratio of at least three times earnings before interest, taxes, depreciation, and amortization to interest expense, as defined in the credit agreement. No amounts were drawn against the credit facility during any of the periods presented.

Long-term Debt

As of June 30, 2014, the total carrying value and estimated fair value of our long-term debt were $20.6 billion and $21.5 billion, respectively. This is compared to a carrying value and estimated fair value of our long-term debt, including the current portion, of $15.6 billion and $15.8 billion, respectively, as of June 30, 2013. These estimated fair values are based on Level 2 inputs.

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The components of our long-term debt and the associated interest rates were as follows as of June 30, 2014 and 2013:

Due Date	Face Value June 30, 2014	Face Value June 30, 2013	Stated Interest Rate	Effective Interest Rate
		(In millions)		
Notes				
September 27, 2013	**$ ***	$ 1,000	**0.875%**	**1.000%**
June 1, 2014	*****	2,000	**2.950%**	**3.049%**
September 25, 2015	**1,750**	1,750	**1.625%**	**1.795%**
February 8, 2016	**750**	750	**2.500%**	**2.642%**
November 15, 2017	**600**	600	**0.875%**	**1.084%**
May 1, 2018	**450**	450	**1.000%**	**1.106%**
December 6, 2018 [a]	**1,250**	*	**1.625%**	**1.824%**
June 1, 2019	**1,000**	1,000	**4.200%**	**4.379%**
October 1, 2020	**1,000**	1,000	**3.000%**	**3.137%**
February 8, 2021	**500**	500	**4.000%**	**4.082%**
December 6, 2021 [b]	**2,396**	*	**2.125%**	**2.233%**
November 15, 2022	**750**	750	**2.125%**	**2.239%**
May 1, 2023	**1,000**	1,000	**2.375%**	**2.465%**
December 15, 2023 [a]	**1,500**	*	**3.625%**	**3.726%**
December 6, 2028 [b]	**2,396**	*	**3.125%**	**3.218%**
May 2, 2033 [c]	**753**	715	**2.625%**	**2.690%**
June 1, 2039	**750**	750	**5.200%**	**5.240%**
October 1, 2040	**1,000**	1,000	**4.500%**	**4.567%**
February 8, 2041	**1,000**	1,000	**5.300%**	**5.361%**
November 15, 2042	**900**	900	**3.500%**	**3.571%**
May 1, 2043	**500**	500	**3.750%**	**3.829%**
December 15, 2043 [a]	**500**	*	**4.875%**	**4.918%**
Total	**$ 20,745**	$ 15,665		

(a) *In December 2013, we issued $3.3 billion of debt securities.*
(b) *In December 2013, we issued 3.5 billion of debt securities.*
(c) *In April 2013, we issued 550 million of debt securities.*
* *Not applicable.*

The notes in this table are senior unsecured obligations and rank equally with our other senior unsecured debt outstanding. Interest on these notes is paid semi-annually, except for the euro-denominated debt securities on which interest is paid annually. Cash paid for interest on our debt for fiscal years 2014, 2013, and 2012 was $509 million, $371 million, and $344 million, respectively. As of June 30, 2014 and 2013, the aggregate unamortized discount for our long-term debt, including the current portion, was $100 million and $65 million, respectively.

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Debt Service

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

(In millions)	
Year Ending June 30,	
2015	$ 0
2016	2,500
2017	0
2018	1,050
2019	2,250
Thereafter	14,945
Total	$ 20,745

NOTE 13 INCOME TAXES

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

(In millions)			
Year Ended June 30,	**2014**	**2013**	**2012**
Current Taxes			
U.S. federal	**$ 3,738**	$ 3,131	$ 2,235
U.S. state and local	**266**	332	153
Foreign	**2,073**	1,745	1,947
Current taxes	**6,077**	5,208	4,335
Deferred Taxes			
Deferred taxes	**(331)**	(19)	954
Provision for income taxes	**$ 5,746**	$ 5,189	$ 5,289

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

(In millions)

Year Ended June 30,	2014	2013	2012
U.S.	**$ 7,127**	$ 6,674	$ 1,600
Foreign	**20,693**	20,378	20,667
Income before income taxes	**$ 27,820**	$ 27,052	$ 22,267

The items accounting for the difference between income taxes computed at the U.S. federal statutory rate and our effective rate were as follows:

Year Ended June 30,	2014	2013	2012
Federal statutory rate	**35.0%**	35.0%	35.0%
Effect of:			
Foreign earnings taxed at lower rates	**(17.1)%**	(17.5)%	(21.1)%
Goodwill impairment	**0%**	0%	9.7%
Other reconciling items, net	**2.8%**	1.7%	0.2%
Effective rate	**20.7%**	19.2%	23.8%

The reduction from the federal statutory rate from foreign earnings taxed at lower rates results from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore, and

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Puerto Rico. Our foreign earnings, which are taxed at rates lower than the U.S. rate and are generated from our regional operating centers, were 81%, 79%, and 79% of our foreign income before tax in fiscal years 2014, 2013, and 2012, respectively. In general, other reconciling items consist of interest, adjustments for intercompany transfer pricing, U.S. state income taxes, domestic production deductions, and credits. In fiscal years 2014, 2013, and 2012, there were no individually significant other reconciling items.

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

(In millions)

June 30,	**2014**	**2013**
Deferred Income Tax Assets		
Stock-based compensation expense	**$ 903**	$ 888
Other expense items	**1,112**	917
Unearned revenue	**520**	445
Impaired investments	**209**	246
Loss carryforwards	**922**	715
Other revenue items	**64**	55
Deferred income tax assets	**$ 3,730**	$ 3,266
Less valuation allowance	**(903)**	(579)
Deferred income tax assets, net of valuation allowance	**$ 2,827**	$ 2,687
Deferred Income Tax Liabilities		
Foreign earnings	**$ (1,140)**	$ (1,146)
Unrealized gain on investments	**(1,911)**	(1,012)
Depreciation and amortization	**(470)**	(604)
Other	**(87)**	(2)
Deferred income tax liabilities	**$ (3,608)**	$ (2,764)
Net deferred income tax assets (liabilities)	**$ (781)**	$ (77)
Reported As		
Current deferred income tax assets	**$ 1,941**	$ 1,632
Other current liabilities	**(125)**	0
Other long-term assets	**131**	0
Long-term deferred income tax liabilities	**(2,728)**	(1,709)
Net deferred income tax assets (liabilities)	**$ (781)**	$ (77)

As of June 30, 2014, we had net operating loss carryforwards of $3.6 billion, including $2.2 billion of foreign net operating loss carryforwards acquired through our acquisition of Skype, and $545 million through our acquisition of NDS. The valuation allowance disclosed in the table above relates to the foreign net operating loss carryforwards and other net deferred tax assets that may not be realized.

Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases and are stated at enacted tax rates expected to be in effect when the taxes are actually paid or recovered.

As of June 30, 2014, we have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $92.9 billion resulting from earnings for certain non-U.S. subsidiaries which are permanently reinvested outside the U.S. The unrecognized deferred tax liability associated with these temporary differences was approximately $29.6 billion at June 30, 2014.

Income taxes paid were $5.5 billion, $3.9 billion, and $3.5 billion in fiscal years 2014, 2013, and 2012, respectively.

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Uncertain Tax Positions

Unrecognized tax benefits as of June 30, 2014, 2013, and 2012, were $8.7 billion, $8.6 billion, and $7.2 billion, respectively. If recognized, these tax benefits would affect our effective tax rates for fiscal years 2014, 2013, and 2012, by $7.0 billion, $6.5 billion, and $6.2 billion, respectively.

As of June 30, 2014, 2013, and 2012, we had accrued interest expense related to uncertain tax positions of $1.5 billion, $1.3 billion, and $939 million, respectively, net of federal income tax benefits. Interest expense on unrecognized tax benefits was $235 million, $400 million, and $154 million in fiscal years 2014, 2013, and 2012, respectively.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Balance, beginning of year	**$ 8,648**	$ 7,202	$ 6,935
Decreases related to settlements	**(583)**	(30)	(16)
Increases for tax positions related to the current year	**566**	612	481
Increases for tax positions related to prior years	**217**	931	118
Decreases for tax positions related to prior years	**(95)**	(65)	(292)
Decreases due to lapsed statutes of limitations	**(39)**	(2)	(24)
Balance, end of year	**$ 8,714**	$ 8,648	$ 7,202

During the third quarter of fiscal year 2011, we reached a settlement of a portion of an I.R.S. audit of tax years 2004 to 2006, which reduced our income tax expense by $461 million. While we settled a portion of the I.R.S. audit, we remain under audit for these years. In February 2012, the I.R.S. withdrew its 2011 Revenue Agents Report and reopened the audit phase of the examination. As of June 30, 2014, the primary unresolved issue relates to transfer pricing, which could have a significant impact on our consolidated financial statements if not resolved favorably. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2013.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2013, some of which are currently under audit by local tax authorities. The resolutions of these audits are not expected to be material to our consolidated financial statements.

NOTE 14 — UNEARNED REVENUE

Unearned revenue by segment was as follows, with segments with significant balances shown separately:

(In millions)

June 30,	2014	2013
Commercial Licensing	**$ 19,099**	$ 18,460
Commercial Other	**3,934**	2,272
Rest of the segments	**2,125**	1,667
Total	**$ 25,158**	$ 22,399

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NOTE 15 OTHER LONG-TERM LIABILITIES

(In millions)		
June 30,	**2014**	**2013**
Tax contingencies and other tax liabilities	**$ 10,510**	$ 9,548
Other	**1,084**	452
Total	**$ 11,594**	$ 10,000

NOTE 16 COMMITMENTS AND GUARANTEES

Construction and Operating Leases

We have committed $880 million for constructing new buildings, building improvements, and leasehold improvements as of June 30, 2014.

We have operating leases for most U.S. and international sales and support offices, research and development facilities, manufacturing facilities, and certain equipment. Rental expense for facilities operating leases was $874 million, $711 million, and $639 million, in fiscal years 2014, 2013, and 2012, respectively. Future minimum rental commitments under non-cancellable facilities operating leases in place as of June 30, 2014 are as follows:

(In millions)	
Year Ending June 30,	
2015	$ 878
2016	748
2017	671
2018	598
2019	456
Thereafter	1,063
Total	$ 4,414

Indemnifications

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. We evaluate estimated losses for these indemnifications, and we consider such factors as the degree of probability of an unfavorable outcome and the 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 any liabilities related to these indemnifications in our consolidated financial statements.

NOTE 17   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 between 1999 and 2005.

We obtained dismissals or reached settlements of all claims made in the United States. 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-

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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. We estimate the total remaining cost of the settlements is approximately $400 million, all of which had been accrued as of June 30, 2014.

Three similar 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. The plaintiffs successfully appealed a British Columbia Court of Appeal decision reversing class certification and dismissing the case. In October 2013, the Canadian Supreme Court reversed the appellate court and reinstated part of the British Columbia case, which is now scheduled for trial in September 2015. The other two cases were inactive pending action by the Supreme Court on the British Columbia case.

Other Antitrust Litigation and Claims

Novell litigation

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. After the trial court dismissed or granted summary judgment on a number of Novell s claims, trial of the one remaining claim took place in late 2011 and resulted in a mistrial. In July 2012, the trial court granted Microsoft s motion for judgment as a matter of law. Novell appealed this decision to the U.S. Court of Appeals for the Tenth Circuit, which affirmed the trial court s decision in September 2013. The Supreme Court denied Novell s petition for review in April 2014.

Go Computer litigation

In June 2005, GO Computer Inc. and co-founder Jerry Kaplan filed a complaint in California state court asserting antitrust claims under the Cartwright Act related to the business of the former GO Corporation in the early 1990s and its successor in interest, Lucent Corporation in the early 2000s. All claims prior to June 2001 have been dismissed with prejudice as barred by the statute of limitations. After a mini-trial on standing issues, the case is now moving forward with discovery, and a trial is set for September 2015.

China State Administration for Industry and Commerce investigation

On July 28, 2014, Microsoft was informed that China s State Administration for Industry and Commerce (SAIC) had begun a formal investigation relating to China s Anti-Monopoly Law, and the SAIC conducted onsite inspections of Microsoft offices in Beijing, Shanghai, Guangzhou, and Chengdu. SAIC has stated the investigation relates to compatibility, bundle sales, and file verification issues related to Windows and Office software.

Patent and Intellectual Property Claims

Motorola litigation

In October 2010, Microsoft filed patent infringement complaints against Motorola Mobility (Motorola) with the International Trade Commission (ITC) and in U.S. District Court in Seattle for infringement of nine Microsoft patents by Motorola s Android devices. Since then, Microsoft and Motorola have filed additional claims against each other with the ITC, in federal district courts in Seattle, Wisconsin, Florida, and California, and in courts in Germany and the United Kingdom. The nature of the claims asserted and status of individual matters are summarized below.

International Trade Commission

In May 2012, the ITC issued a limited exclusion order against Motorola on one Microsoft patent, which became effective in July 2012 and was affirmed on appeal in December 2013. In July 2013, Microsoft filed an action in U.S. District Court in Washington, D.C. seeking an order to compel enforcement of the ITC s May 2012 import ban against infringing Motorola products by the Bureau of Customs and Border Protection (CBP), after learning that CBP had failed to fully enforce the order.

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In November 2010, Motorola filed an action against Microsoft with the ITC alleging infringement of five Motorola patents by Xbox consoles and accessories and seeking an exclusion order to prohibit importation of the allegedly infringing Xbox products. At Motorola s request, the ITC terminated its investigation of four Motorola patents. In March 2013, the ITC affirmed there was no violation of the remaining Motorola patent. Motorola appealed the ITC s decision to the U.S. Court of Appeals for the Federal Circuit.

U.S. District Court

The Seattle District Court case filed in October 2010 by Microsoft as a companion to Microsoft s ITC case against Motorola was stayed pending the outcome of the ITC case.

In November 2010, Microsoft sued Motorola for breach of contract in U.S. District Court in Seattle, alleging that Motorola breached its commitments to standards-setting organizations to license to Microsoft certain patents on reasonable and non-discriminatory (RAND) terms and conditions. Motorola has declared these patents essential to the implementation of the H.264 video standard and the 802.11 Wi-Fi standard. In the Motorola ITC case described above and in suits described below, Motorola or a Motorola affiliate subsequently sued Microsoft on those patents in U.S. District Courts, in the ITC, and in Germany. In February 2012, the Seattle District Court granted a partial summary judgment in favor of Microsoft ruling that (1) Motorola had committed to standards organizations to license its declared-essential patents on RAND terms and conditions; and (2) Microsoft is a third-party beneficiary of those commitments. After trial, the Seattle District Court set per unit royalties for Motorola s H.264 and 802.11 patents, which resulted in an immaterial Microsoft liability. In September 2013, following trial of Microsoft s breach of contract claim, a jury awarded $14.5 million in damages to Microsoft. Motorola appealed.

Cases filed by Motorola in Wisconsin, California, and Florida, with the exception of one currently stayed case in Wisconsin (a companion case to Motorola s ITC action), have been transferred to the U.S District Court in Seattle. Motorola and Microsoft both seek damages as well as injunctive relief. The court has stayed these cases on agreement of the parties.

In the transferred cases, Motorola asserts 15 patents are infringed by a range of Microsoft products including mobile and PC operating system, productivity, server, communication, browser and gaming products.

In the Motorola action originally filed in California, Motorola asserts Microsoft violated antitrust laws in connection with Microsoft s assertion of patents against Motorola that Microsoft agreed to license to certain qualifying entities on RAND terms and conditions.

In counterclaims, Microsoft asserts 14 patents are infringed by Motorola Android devices and certain Motorola digital video recorders.

Germany

In July 2011, Motorola filed patent infringement actions in Germany against Microsoft and several Microsoft subsidiaries.

Motorola asserts two patents (one now expired) are essential to implementation of the H.264 video standard, and Motorola alleges that H.264 capable products including Xbox 360, Windows 7, Media Player, and Internet Explorer infringe those patents. In May 2012, the court issued an injunction relating to all H.264 capable Microsoft products in Germany, which Microsoft appealed. Orders in the litigation pending in Seattle, Washington described above enjoin Motorola from enforcing the German injunction.

Motorola asserts that one patent covers certain syncing functionality in the ActiveSync protocol employed by Windows Phone 7, Outlook Mobile, Hotmail Mobile, Exchange Online, Exchange Server, and Hotmail Server. In April 2013, the court stayed the case pending the outcome of parallel proceedings in which Microsoft is seeking to invalidate the patent. In November 2013, the Federal Patent Court invalidated the originally issued patent claims, but ruled that certain new amended claims were patentable. Both Motorola and Microsoft appealed. In June 2014, the court reopened infringement proceedings and scheduled a hearing in November 2014.

Microsoft may be able to mitigate the adverse impact of any injunction by altering its products to avoid Motorola s infringement claims.

Any damages would be determined in separate proceedings.

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In lawsuits Microsoft filed in Germany in 2011 and 2012, Microsoft asserts that Motorola Android devices infringe Microsoft patents and is seeking damages and injunctions. In 2012, regional courts in Germany issued injunctions on three of the Microsoft patents, which Motorola appealed. One judgment has been affirmed on appeal (and Motorola has further appealed), and the other two appeals are pending. In actions filed separately by Motorola to invalidate these patents, the Federal Patent Court in 2013 and 2014 held the Microsoft patents invalid, and Microsoft appealed. For the cases in which Microsoft obtained injunctions, if Motorola were to prevail following all appeals, Motorola could have a claim against Microsoft for damages caused by an erroneously granted injunction.

United Kingdom

In December 2011, Microsoft filed an action against Motorola in the High Court of Justice, Chancery Division, Patents Court, in London, England, seeking to revoke the UK part of the European patent asserted by Motorola in Germany against the ActiveSync protocol. In February 2012, Motorola counterclaimed alleging infringement of the patent and seeking damages and an injunction. In December 2012, the court ruled that Motorola s patent is invalid. The court also ruled that the patent, even if valid, would be licensed under the grant-back clause in Google s ActiveSync license. Motorola appealed and the appeals court affirmed the lower court s ruling in Microsoft s favor in November 2013. Motorola has exhausted all appeals and the rulings in Microsoft s favor are final.

IPCom patent litigation

IPCom GmbH & Co. is a German company that holds a large portfolio of mobile technology related patents spanning about 170 patent families and addressing a broad range of cellular technologies. IPCom has asserted 19 of these patents in litigation against Nokia and many of the leading cell phone companies and operators. Three of the infringement suits against Nokia (now assumed by Microsoft through the NDS acquisition) are still pending in courts in Germany, England, and Italy. These courts have held a number of IPCom s patents were invalid or not infringed. We continue to contest the validity or infringement of the patents remaining in dispute.

Interdigital patent litigation

InterDigital Technology Corporation and InterDigital Communications Corporation (collectively, IDT) filed four patent infringement cases against Nokia in the ITC and in U.S. District Court for the District of Delaware between 2007 and 2013. We are being substituted for Nokia in these cases. Each case includes other co-defendants because most of the patents at issue allegedly relate to 3G and 4G wireless communications standards essential functionality. The suite of cases include three ITC investigations where IDT is seeking an order excluding importation of 3G and 4G phones into the U.S. and one active case in U.S. District Court in Delaware seeking an injunction and damages.

European copyright levies

We have assumed from Nokia all potential liability due to Nokia s alleged failure to pay private copying levies in various European countries based upon sale of memory cards and mobile phones that incorporate blank memory. The levies are based upon a 2001 EU Directive establishing a right for end users to make copies of copyrighted works for personal or private use, but also allowing the collection of levies based upon sales of blank media or recording devices to compensate copyright holders for private copying. Various collecting societies in EU countries initiated litigation against Nokia, stating that Nokia must pay levies not only based upon sales of blank memory cards, but also phones that include blank memory for data storage on the phones, regardless of actual usage of that memory. The most significant cases against Nokia are pending in Germany and Austria, due to both high volume of sales and high levy amounts sought in these countries. We are litigating against certain collecting societies on the basis that the levy schemes exceed what the EU Directive and European Court of Justice decisions permit.

Other patent and intellectual property claims

In addition to these cases, there are approximately 90 other patent infringement cases pending against Microsoft.

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Product-Related Litigation

U.S. cell phone litigation

Nokia, along with other handset manufacturers and network operators, is a defendant in 19 lawsuits filed in the Superior Court for the District of Columbia by individual plaintiffs who allege that radio emissions from cellular handsets caused their brain tumors and other adverse health effects. We have assumed responsibility for these claims as part of the NDS acquisition. Nine of these cases were filed in 2002 and are consolidated for certain pre-trial proceedings; the remaining ten cases are stayed. In a separate 2009 decision, the Court of Appeals for the District of Columbia held that adverse health effect claims arising from the use of cellular handsets that operate within the U.S. Federal Communications Commission radio frequency emission guidelines (FCC Guidelines) are pre-empted by federal law. The plaintiffs allege that their handsets either operated outside the FCC Guidelines or were manufactured before the FCC Guidelines went into effect. The lawsuits also allege an industry-wide conspiracy to manipulate the science and testing around emission guidelines. In September 2013, defendants in the consolidated cases moved to exclude plaintiffs expert evidence of general causation on the basis of flawed scientific methodologies. The motion was heard in December 2013 and January 2014. In March 2014, defendants filed a separate motion to preclude plaintiffs general causation testimony on the ground that it is pre-empted by federal law because the experts challenge the safety of all cellular handsets, including those that comply with the FCC Guidelines. Both motions are pending.

Canadian cell phone class action

Nokia, along with other handset manufacturers and network operators, is a defendant in a 2013 class action lawsuit filed in the Supreme Court of British Columbia by a purported class of Canadians who have used cellular phones for at least 1600 hours, including a subclass of users with brain tumors. Microsoft was served with the complaint in June 2014. The litigation is not yet active as several defendants remain to be served.

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 consolidated financial statements, these matters are subject to inherent uncertainties and management s view of these matters may change in the future.

As of June 30, 2014, we had accrued aggregate liabilities of $780 million in other current liabilities and $81 million in other long-term liabilities for all of our legal matters that were contingencies as of that date. While we intend to defend these matters vigorously, adverse outcomes that we estimate could reach approximately $2.0 billion 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 consolidated financial statements for the period in which the effects become reasonably estimable. Substantially all changes from the prior quarter in these accruals and estimates are attributable to matters involving Nokia that we assumed as a result of the NDS acquisition.

NOTE 18 STOCKHOLDERS EQUITY

Shares Outstanding

Shares of common stock outstanding were as follows:

(In millions)

Year Ended June 30,	2014	2013	2012
Balance, beginning of year	**8,328**	8,381	8,376
Issued	**86**	105	147
Repurchased	**(175)**	(158)	(142)
Balance, end of year	**8,239**	8,328	8,381

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Share Repurchases

On September 16, 2013, our Board of Directors approved a new share repurchase program authorizing up to $40.0 billion in share repurchases. The share repurchase program became effective on October 1, 2013, has no expiration date, and may be suspended or discontinued at any time without notice. This new share repurchase program replaced the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013. As of June 30, 2014, $35.1 billion remained of our $40.0 billion share repurchase program. All repurchases were made using cash resources.

We repurchased the following shares of common stock under the above-described repurchase plans:

(In millions)	**Shares**	**Amount**	**Shares**	**Amount**	**Shares**	**Amount**
Year Ended June 30,	**2014** [(a)]		**2013** [(b)]		**2012** [(b)]	
First quarter	**47**	**$ 1,500**	33	$ 1,000	38	$ 1,000
Second quarter	**53**	**2,000**	58	1,607	39	1,000
Third quarter	**47**	**1,791**	36	1,000	31	1,000
Fourth quarter	**28**	**1,118**	31	1,000	34	1,000
Total	**175**	**$ 6,409**	158	$ 4,607	142	$ 4,000

(a) *Of the 175 million shares repurchased in fiscal year 2014, 128 million shares were repurchased for $4.9 billion under the share repurchase program approved by our Board of Directors on September 16, 2013 and 47 million shares were repurchased for $1.5 billion under the share repurchase program that was announced on September 22, 2008 and expired on September 30, 2013.*

(b) *All shares repurchased in fiscal years 2013 and 2012 were repurchased under the repurchase plan that was announced on September 22, 2008 and expired on September 30, 2013.*

The above table excludes shares repurchased to settle statutory employee tax withholding related to the vesting of stock awards.

Dividends

In fiscal year 2014, our Board of Directors declared the following dividends:

Declaration Date	**Dividend Per Share**	**Record Date**	**Total Amount**	**Payment Date**
			(In millions)	
September 16, 2013	**$ 0.28**	**November 21, 2013**	**$ 2,332**	**December 12, 2013**
November 19, 2013	**$ 0.28**	**February 20, 2014**	**$ 2,322**	**March 13, 2014**
March 11, 2014	**$ 0.28**	**May 15, 2014**	**$ 2,309**	**June 12, 2014**

June 10, 2014	**$ 0.28**	**August 21, 2014**	**$ 2,307**	**September 11, 2014**

The dividend declared on June 10, 2014 will be paid after the filing date of this Form 10-K and was included in other current liabilities as of June 30, 2014.

In fiscal year 2013, our Board of Directors declared the following dividends:

Declaration Date	**Dividend Per Share**	**Record Date**	**Total Amount**	**Payment Date**
			(In millions)	
September 18, 2012	$ 0.23	November 15, 2012	$ 1,933	December 13, 2012
November 28, 2012	$ 0.23	February 21, 2013	$ 1,925	March 14, 2013
March 11, 2013	$ 0.23	May 16, 2013	$ 1,921	June 13, 2013
June 12, 2013	$ 0.23	August 15, 2013	$ 1,916	September 12, 2013

The dividend declared on June 12, 2013 was included in other current liabilities as of June 30, 2013.

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NOTE 19 ACCUMULATED OTHER COMPREHENSIVE INCOME

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

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Derivatives			
Accumulated other comprehensive income (loss) balance, beginning of period	**$ 66**	$ 92	$ (163)
Unrealized gains (losses), net of tax effects of **$2**, $54 and $127	**63**	101	236
Reclassification adjustments for losses (gains) included in revenue	**(104)**	(195)	29
Tax expense (benefit) included in provision for income taxes	**6**	68	(10)
Amounts reclassified from accumulated other comprehensive income	**(98)**	(127)	19
Net current period other comprehensive income (loss)	**(35)**	(26)	255
Accumulated other comprehensive income balance, end of period	**$ 31**	$ 66	$ 92
Investments			
Accumulated other comprehensive income balance, beginning of period	**$ 1,794**	$ 1,431	$ 1,821
Unrealized gains (losses), net of tax effects of **$1,067**, $244 and $(93)	**2,053**	453	(172)
Reclassification adjustments for gains included in other income (expense)	**(447)**	(139)	(335)
Tax expense included in provision for income taxes	**131**	49	117
Amounts reclassified from accumulated other comprehensive income	**(316)**	(90)	(218)
Net current period other comprehensive income (loss)	**1,737**	363	(390)
Accumulated other comprehensive income balance, end of period	**$ 3,531**	$ 1,794	$ 1,431
Translation Adjustments and Other			
Accumulated other comprehensive income (loss) balance, beginning of period	**$ (117)**	$ (101)	$ 205
Translation adjustments and other, net of tax effects of **$12**, $(8) and $(165)	**263**	(16)	(306)
Accumulated other comprehensive loss balance, end of period	**$ 146**	$ (117)	$ (101)
Accumulated other comprehensive income, end of period	**$ 3,708**	$ 1,743	$ 1,422

NOTE 20 EMPLOYEE STOCK AND SAVINGS PLANS

We grant stock-based compensation to directors and employees. At June 30, 2014, an aggregate of 346 million shares were authorized for future grant under our stock plans, covering stock options, stock awards, and leadership stock awards. Awards that expire or are canceled without delivery of shares generally become available for issuance under the plans. We issue new shares of Microsoft common stock to satisfy exercises and vesting of awards granted under all of our stock plans.

Stock-based compensation expense and related income tax benefits were as follows:

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Stock-based compensation expense	**$ 2,446**	$ 2,406	$ 2,244
Income tax benefits related to stock-based compensation	**$ 830**	$ 842	$ 785

Stock Plans

Stock awards

Stock awards (SAs) are grants that entitle the holder to shares of Microsoft common stock as the award vests. SAs generally vest over a four or five-year period.

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Executive incentive plan

Under the Executive Incentive Plan (EIP), the Compensation Committee awards performance-based compensation comprising both cash and SAs to executive officers and certain senior executives. For executive officers, their awards are based on an aggregate incentive pool equal to a percentage of consolidated operating income. For fiscal years 2014, 2013, and 2012, the pool was 0.44%, 0.35%, and 0.30% of operating income, respectively. The SAs vest ratably in August of each of the four years following the grant date. The final cash awards will be determined after each performance period based on individual and business performance.

Activity for all stock plans

The fair value of each award was estimated on the date of grant using the following assumptions:

Year Ended June 30,	2014	2013	2012
Dividends per share (quarterly amounts)	**$ 0.23 - $ 0.28**	$ 0.20 - $ 0.23	$ 0.16 - $ 0.20
Interest rates range	**1.3% - 1.8%**	0.6% - 1.1%	0.7% - 1.7%

During fiscal year 2014, the following activity occurred under our stock plans:

	Shares	Weighted Average Grant-Date Fair Value
	(In millions)	
Stock Awards		
Nonvested balance, beginning of year	**273**	**$ 25.50**
Granted [(a)]	**103**	**$ 31.50**
Vested	**(93)**	**$ 25.12**
Forfeited	**(24)**	**$ 27.01**
Nonvested balance, end of year	**259**	**$ 27.88**

(a) *Includes four million shares in stock replacement awards related to the acquisition of NDS. The weighted average grant-date fair value was $37.64.*

As of June 30, 2014, there was approximately $5.2 billion of total unrecognized compensation costs related to stock awards. These costs are expected to be recognized over a weighted average period of 3 years.

During fiscal years 2013 and 2012, the following activity occurred under our stock plans:

(In millions, except fair values)	**2013**	**2012**
Stock Awards		
Awards granted	104	110
Weighted average grant-date fair value	$ 28.37	$ 24.60

Total vest-date fair value of stock awards vested was $3.2 billion, $2.8 billion, and $2.4 billion, for fiscal years 2014, 2013, and 2012, respectively.

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Employee Stock Purchase Plan

We have an employee stock purchase plan (the Plan) for all eligible employees. Shares of our common stock may be purchased by employees at three-month intervals at 90% of the fair market value on the last trading day of each three-month period. Employees may purchase shares having a value not exceeding 15% of their gross compensation during an offering period. Employees purchased the following shares during the periods presented:

(Shares in millions)

Year Ended June 30,	2014	2013	2012
Shares purchased	**18**	20	20
Average price per share	**$ 33.60**	$ 26.81	$ 25.03

At June 30, 2014, 173 million shares of our common stock were reserved for future issuance through the Plan.

Savings Plan

We have a savings plan in the U.S. that qualifies under Section 401(k) of the Internal Revenue Code, and a number of savings plans in international locations. Participating U.S. employees may contribute up to 75% of their salary, but not more than statutory limits. We contribute fifty cents for each dollar of the first 6% a participant contributes in this plan, with a maximum contribution of the lesser of 3% of a participant s earnings or 3% of the IRS compensation limit for the given year. Matching contributions for all plans were $420 million, $393 million, and $373 million in fiscal years 2014, 2013, and 2012, respectively, and were expensed as contributed. Matching contributions are invested proportionate to each participant s voluntary contributions in the investment options provided under the plan. Investment options in the U.S. plan include Microsoft common stock, but neither participant nor our matching contributions are required to be invested in Microsoft common stock.

NOTE 21 SEGMENT INFORMATION AND GEOGRAPHIC DATA

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 in this note is reported on that basis.

During the first quarter of fiscal year 2014, we changed our organizational structure as part of our transformation to a devices and services company. As a result, information that our chief operating decision maker regularly reviews for purposes of allocating resources and assessing performance changed. Therefore, beginning in fiscal year 2014, we reported our financial performance based on our new segments; D&C Licensing, D&C Hardware, D&C Other, Commercial Licensing, and Commercial Other. We have recast certain prior period amounts to conform to the way we internally managed and monitored segment performance during fiscal year 2014.

On April 25, 2014, we acquired substantially all of NDS. See Note 9 Business Combinations for additional details. NDS has been included in our consolidated results of operations starting on the acquisition date. We report the financial performance of the acquired business in our new Phone Hardware segment. Prior to the acquisition of NDS, financial results associated with our joint strategic initiatives with Nokia were reflected in our D&C Licensing segment. The contractual relationship with Nokia related to those initiatives terminated in conjunction with the acquisition. With the creation of the new Phone Hardware segment, the D&C Hardware segment was renamed Computing and Gaming Hardware in the fourth quarter of fiscal year 2014.

Our reportable segments are described below.

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Devices and Consumer

Our D&C segments develop, manufacture, market, and support products and services designed to entertain and connect people, increase personal productivity, help people simplify tasks and make more informed decisions online, and help advertisers connect with audiences. Our D&C segments are:

D&C Licensing, comprising: Windows, including all OEM licensing (Windows OEM) and other non-volume licensing and academic volume licensing of the Windows operating system and related software; non-volume licensing of Microsoft Office, comprising the core Office product set, for consumers (Office Consumer); Windows Phone operating system, including related patent licensing; and certain other patent licensing revenue;

Computing and Gaming Hardware, comprising: Xbox gaming and entertainment consoles and accessories, second-party and third-party video game royalties, and Xbox Live subscriptions (Xbox Platform); Surface devices and accessories; and Microsoft PC accessories;

Phone Hardware, comprising: Lumia Smartphones and other non-Lumia phones, beginning with the acquisition of NDS; and

D&C Other, comprising: Resale, including Windows Store, Xbox Live transactions, and Windows Phone Store; search advertising; display advertising; Office 365 Consumer, comprising Office 365 Home and Office 365 Personal; Studios, comprising first-party video games; our retail stores; and certain other consumer products and services not included in the categories above.

Commercial

Our Commercial segments develop, market, and support software and services designed to increase individual, team, and organizational productivity and efficiency, including simplifying everyday tasks through seamless operations across the user s hardware and software. Our Commercial segments are:

Commercial Licensing, comprising: server products, including Windows Server, Microsoft SQL Server, Visual Studio, System Center, and related Client Access Licenses (CALs); Windows Embedded; volume licensing of the Windows operating system, excluding academic (Windows Commercial); Microsoft Office for business, including Office, Exchange, SharePoint, Lync, and related CALs (Office Commercial); Microsoft Dynamics business solutions, excluding Dynamics CRM Online; and Skype; and

Commercial Other, comprising: Enterprise Services, including Premier Support Services and Microsoft Consulting Services; Commercial Cloud, comprising Office 365 Commercial, other Microsoft Office online offerings, Dynamics CRM Online, and Microsoft Azure; and certain other commercial products and online services not included in the categories above.

Revenue and cost of revenue are generally directly attributed to our segments. Certain revenue contracts are allocated among the segments based on the relative value of the underlying products and services. Cost of revenue is directly charged to our hardware segments. For the remaining segments, cost of revenue is directly charged in most cases and allocated in certain cases, generally using a relative revenue methodology.

We do not allocate operating expenses to our segments. Rather, we allocate them to our two segment groups, Devices and Consumer and Commercial. Due to the integrated structure of our business, allocations of expenses are made in certain cases to incent cross-collaboration among our segment groups so that a segment group is not solely burdened by the cost of a mutually beneficial activity as we seek to deliver seamless experiences across devices, whether on-premises or in the cloud.

Operating expenses are attributed to our segment groups as follows:

Sales and marketing expenses are primarily recorded directly to each segment group based on identified customer segment.

Research and development expenses are primarily shared across the segment groups based on relative gross margin but are mapped directly in certain cases where the value of the expense only accrues to that segment group.

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General and administrative expenses are primarily allocated based on relative gross margin. Certain corporate-level activity is not allocated to our segment groups, including costs of: legal, including expenses, settlements, and fines; information technology; human resources; finance; excise taxes; and integration and restructuring costs.

Segment revenue and gross margin were as follows during the periods presented:

(In millions)

Year Ended June 30,		**2014**	**2013**	**2012**
Revenue				
Devices and Consumer	Licensing	**$ 18,803**	$ 19,021	$ 19,495
	Hardware:			
	Computing and Gaming Hardware	**9,628**	6,461	6,740
	Phone Hardware	**1,985**	0	0
	Total D&C Hardware	**11,613**	6,461	6,740
	Other	**7,258**	6,618	6,203
	Total Devices and Consumer	**37,674**	32,100	32,438
Commercial	Licensing	**42,027**	39,686	37,126
	Other	**7,547**	5,660	4,644
	Total Commercial	**49,574**	45,346	41,770
Corporate and Other		**(415)**	403	(485)
Total revenue		**$ 86,833**	$ 77,849	$ 73,723

(In millions)

Year Ended June 30,		**2014**	**2013**	**2012**
Gross margin				
Devices and Consumer	Licensing	**$ 17,216**	$ 17,044	$ 17,240
	Hardware:			
	Computing and Gaming Hardware	**893**	956	2,495
	Phone Hardware	**54**	0	0
	Total D&C Hardware	**947**	956	2,495
	Other	**1,770**	2,046	1,998

	Total Devices and Consumer	**19,933**	20,046	21,733
Commercial	Licensing	**38,604**	36,261	34,463
	Other	**1,856**	921	579
	Total Commercial	**40,460**	37,182	35,042
Corporate and Other		**(494)**	372	(582)
Total gross margin		**$ 59,899**	$ 57,600	$ 56,193

Following is operating expenses by segment group. As discussed above, we do not allocate operating expenses below cost of revenue to our segments.

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Devices and Consumer	**$ 11,219**	$ 10,625	$ 15,682
Commercial	**16,993**	16,050	15,064
Corporate and Other	**3,928**	4,161	3,684
Total operating expenses	**$ 32,140**	$ 30,836	$ 34,430

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Following is operating income (loss) by segment group.

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Devices and Consumer	**$ 8,714**	$ 9,421	$ 6,051
Commercial	**23,467**	21,132	19,978
Corporate and Other	**(4,422)**	(3,789)	(4,266)
Total operating income	**$ 27,759**	$ 26,764	$ 21,763

Corporate and Other operating income includes 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.

Corporate and Other activity was as follows:

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Corporate [(a)]	**$ (3,888)**	$ (4,236)	$ (3,671)
Other (adjustments to U.S. GAAP):			
Revenue reconciling amounts [(b)]	**(415)**	403	(485)
Cost of revenue reconciling amounts	**(79)**	(31)	(97)
Operating expenses reconciling amounts	**(40)**	75	(13)
Total Corporate and Other	**$ (4,422)**	$ (3,789)	$ (4,266)

(a) *Corporate is presented on the basis of our internal accounting policies and excludes the adjustments to U.S. GAAP that are presented separately in those line items.*

(b) *Revenue reconciling amounts for fiscal year 2014 included a net $349 million of revenue deferrals related to sales of certain devices bundled with other products and services (Bundled Offerings). Revenue reconciling amounts for fiscal years 2012 and 2013 included the deferral and subsequent recognition, respectively, of $540 million of revenue related to the Windows Upgrade Offer.*

No sales to an individual customer or country other than the United States accounted for more than 10% of fiscal year 2014, 2013, or 2012 revenue. Revenue, classified by the major geographic areas in which our customers are located, was as follows:

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
United States [(a)]	**$ 43,474**	$ 41,344	$ 38,846
Other countries	**43,359**	36,505	34,877
Total	**$ 86,833**	$ 77,849	$ 73,723

(a) *Includes billings to OEMs and certain multinational organizations because of the nature of these businesses and the impracticability of determining the geographic source of the revenue.*

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Revenue from external customers, classified by significant product and service offerings were as follows:

(In millions)

Year Ended June 30,	**2014**	**2013**	**2012**
Microsoft Office system	**$ 24,323**	$ 22,995	$ 22,299
Windows PC operating system	**16,856**	17,529	17,320
Server products and tools	**17,055**	15,408	14,232
Xbox Platform	**8,643**	7,100	8,045
Consulting and product support services	**4,767**	4,372	3,976
Advertising	**4,016**	3,387	3,181
Phone	**3,073**	615	162
Surface	**1,883**	853	0
Other	**6,217**	5,590	4,508
Total	**$ 86,833**	$ 77,849	$ 73,723

Our total Commercial Cloud revenue was $2.8 billion, $1.3 billion, and $0.7 billion in fiscal years 2014, 2013, and 2012, respectively. These amounts are included in their respective product categories in the table above.

Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is charged to the respective segment. It is impracticable for us to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

Long-lived assets, excluding financial instruments and tax assets, classified by the location of the controlling statutory company and with countries over 10% of the total shown separately, were as follows:

(In millions)

June 30,	**2014**	**2013**	**2012**
United States	**$ 17,653**	$ 16,615	$ 14,081
Finland	**9,840**	12	8
Luxembourg	**6,913**	6,943	6,975
Other countries	**5,713**	4,159	3,827
Total	**$ 40,119**	$ 27,729	$ 24,891

NOTE 22 QUARTERLY INFORMATION (UNAUDITED)

(In millions, except per share amounts)

Quarter Ended	September 30	December 31	March 31	June 30 (a)	Total (a)
Fiscal Year 2014					
Revenue	**$ 18,529**	**$ 24,519**	**$ 20,403**	**$ 23,382**	**$ 86,833**
Gross margin	**13,415**	**16,235**	**14,462**	**15,787**	**59,899**
Net income	**5,244**	**6,558**	**5,660**	**4,612** (b)	**22,074** (b)
Basic earnings per share	**0.63**	**0.79**	**0.68**	**0.56**	**2.66**
Diluted earnings per share	**0.62**	**0.78**	**0.68**	**0.55** (b)	**2.63** (b)
Fiscal Year 2013					
Revenue	$ 16,008	$ 21,456	$ 20,489	$ 19,896	$ 77,849
Gross margin	11,840	15,764	15,702	14,294	57,600
Net income	4,466	6,377	6,055 (c)	4,965 (d)	21,863 (e)
Basic earnings per share	0.53	0.76	0.72	0.59	2.61
Diluted earnings per share	0.53	0.76	0.72 (c)	0.59 (d)	2.58 (e)

(a) *NDS has been included in our consolidated results of operations starting on April 25, 2014, the date of acquisition.*

(b) *Includes a tax provision adjustment recorded in the fourth quarter of fiscal year 2014 related to adjustments to prior years liabilities for intercompany transfer pricing which decreased net income by $458 million and diluted earnings per share by $0.05.*

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(c) *Includes a charge related to a fine imposed by the European Commission in March 2013 which decreased net income by $733 million (561 million) and diluted earnings per share by $0.09.*
(d) *Includes a charge for Surface RT inventory adjustments recorded in the fourth quarter of fiscal year 2013, which decreased net income by $596 million and diluted earnings per share by $0.07.*
(e) *Includes a charge related to a fine imposed by the European Commission in March 2013 which decreased net income by $733 million (561 million) and diluted earnings per share by $0.09. Also includes a charge for Surface RT inventory adjustments recorded in the fourth quarter of fiscal year 2013, which decreased net income by $596 million and diluted earnings per share by $0.07.*

NOTE 23 SUBSEQUENT EVENT

On July 17, 2014, we announced a restructuring plan to simplify our organization and align the recently acquired NDS business with our company s overall strategy. We will eliminate up to 18,000 positions over the next year, including 12,500 professional and factory positions related to the acquisition of NDS. We expect to incur pre-tax charges of approximately $1.1 billion to $1.6 billion in fiscal year 2015.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the Company) as of June 30, 2014 and 2013, and the related consolidated statements of income, comprehensive income, cash flows, and stockholders equity for each of the three years in the period ended June 30, 2014. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 2014 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2014, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of June 30, 2014, based on the criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated July 31, 2014, expressed an unqualified opinion on the Company s internal control over financial reporting.

/s/ Deloitte & Touche LLP

Seattle, Washington

July 31, 2014

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

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

REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Our assessment of, and conclusion on, the effectiveness of internal control over financial reporting did not include the internal controls of Nokia Corporation s Devices and Services business, acquired on April 25, 2014, which is included in our 2014 consolidated financial statements and represented approximately 9% of our total assets as of June 30, 2014, and 2% of our total revenues for the year ended June 30, 2014. Based on this evaluation, management concluded that the company s internal control over financial reporting was effective as of June 30, 2014. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Deloitte & Touche LLP has audited our internal control over financial reporting as of June 30, 2014; their report is included in Item 9A.

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Item 9A

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have audited the internal control over financial reporting of Microsoft Corporation and subsidiaries (the Company) as of June 30, 2014, based on criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. As described in the Report of Management on Internal Control over Financial Reporting, management excluded from its assessment the internal control over financial reporting at Nokia Corporation s Devices and Services business, acquired on April 25, 2014 and whose financial statements constitute 9% of total assets as of June 30, 2014 and 2% of total revenues for the year ended June 30, 2014. Accordingly, our audit did not include the internal control over financial reporting at Nokia Corporation s Devices and Services business. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

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

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

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2014, based on the criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended June 30, 2014, of the Company and our report dated July 31, 2014, expressed an unqualified opinion on those financial statements.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington

July 31, 2014

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Item 9B, 10, 11, 12, 13, 14

ITEM 9B. OTHER INFORMATION

Effective July 1, 2014, we amended our Bylaws to establish the size of the Board of Directors as a range of 5 to 14 members, and to designate the chief executive officer as the sole officer with authority to appoint corporate officers. The amended Bylaws are filed as Exhibit 3.2 to this Report.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

A list of our executive officers and biographical information appears in Part I, Item 1 of this Form 10-K. Information about our directors may be found under the caption Our director nominees in our Proxy Statement for the Annual Meeting of Shareholders to be held December 3, 2014 (the Proxy Statement). Information about our Audit Committee may be found under the caption Board committees in the Proxy Statement. That information is incorporated herein by reference.

The information in the Proxy Statement set forth under the caption Section 16(a) Beneficial ownership reporting compliance is incorporated herein by reference.

We have adopted the Microsoft Finance Code of Professional Conduct (the finance code of ethics), a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, Chief Accounting Officer and Corporate Controller, and other finance organization employees. The finance code of ethics is publicly available on our website at www.microsoft.com/investor/MSFinanceCode. If we make any substantive amendments to the finance code of ethics or grant any waiver, including any implicit waiver, from a provision of the code to our Chief Executive Officer, Chief Financial Officer, or Chief Accounting Officer and Corporate Controller, we will disclose the nature of the amendment or waiver on that website or in a report on Form 8-K.

ITEM 11. EXECUTIVE COMPENSATION

The information in the Proxy Statement set forth under the captions Director compensation, Named executive officer compensation, Compensation Committee interlocks and insider participation, and Compensation Committee report is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information in the Proxy Statement set forth under the captions Information regarding beneficial ownership of principal shareholders, directors, and management and Equity compensation plan information is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information set forth in the Proxy Statement under the captions Director independence and Certain relationships and related transactions is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information concerning principal accountant fees and services appears in the Proxy Statement under the headings Fees billed by Deloitte & Touche and Policy on Audit Committee pre-approval of audit and permissible non-audit services of independent auditor and is incorporated herein by reference.

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PART IV

Item 15

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Financial Statements and Schedules

The financial statements are set forth under Item 8 of this Form 10-K, as indexed below. Financial statement schedules have been omitted since they either are not required, not applicable, or the information is otherwise included.

Index to Financial Statements	Page
Income Statements	53
Comprehensive Income Statements	54
Balance Sheets	55
Cash Flows Statements	56
Stockholders Equity Statements	57
Notes to Financial Statements	58
Report of Independent Registered Public Accounting Firm	97

(b) Exhibit Listing

		Filed		Incorporated by Reference Period		
Exhibit Number	**Exhibit Description**	**Herewith**	**Form**	**Ending**	**Exhibit**	**Filing Date**
3.1	Amended and Restated Articles of Incorporation of Microsoft Corporation		10-Q	12/31/09	3.1	1/28/10
3.2	Bylaws of Microsoft Corporation	X				
4.1	Form of Indenture between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee (Base Indenture)		3-ASR		4.1	11/20/08
4.2	Form of First Supplemental Indenture for 2.95% Notes due 2014, 4.20% Notes due 2019, and 5.20% Notes due 2039, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Base Indenture		8-K		4.2	5/15/09
4.5			8-K		4.5	9/27/10

Form of Second Supplemental Indenture for 0.875% Notes due 2013, 1.625% Notes due 2015, 3.00% Notes due 2020, and 4.50% Notes due 2040, dated as of September 27, 2010, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee

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Exhibit Number	Exhibit Description	Filed Herewith	Form	Incorporated by Reference Period Ending	Exhibit	Filing Date
4.6	Third Supplemental Indenture for 2.500% Notes due 2016, 4.000% Notes due 2021, and 5.300% Notes due 2041, dated as of February 8, 2011, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee		8-K		4.6	2/8/11
4.7	Fourth Supplemental Indenture for 0.875% Notes due 2017, 2.125% Notes due 2022, and 3.500% Notes due 2042, dated as of November 7, 2012, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee		8-K		4.7	11/7/12
4.8	Fifth Supplemental Indenture for 2.625% Notes due 2033, dated as of May 2, 2013 between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee		8-K		4.1	5/1/13
4.9	Sixth Supplemental Indenture for 1.000% Notes due 2018, 2.375% Notes due 2023, and 3.750% Notes due 2043, dated as of May 2, 2013, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee		8-K		4.2	5/1/13
4.10	Seventh Supplemental Indenture for 2.125% Notes due 2021 and 3.125% Notes due 2028, dated as of December 6, 2013, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee		8-K		4.1	12/6/13

PART IV

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Exhibit Number	Exhibit Description	Filed Herewith	Form	Incorporated by Reference Period Ending	Exhibit	Filing Date
4.11	Eighth Supplemental Indenture for 1.625% Notes due 2018, 3.625% Notes due 2023, and 4.875% Notes due 2043, dated as of December 6, 2013, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee		8-K		4.2	12/6/13
10.1*	Microsoft Corporation 2001 Stock Plan		10-Q	12/31/11	10.1	1/19/12
10.3*	Microsoft Corporation 1999 Stock Plan for Non-Employee Directors		8-K		10.3	11/15/04
10.4*	Microsoft Corporation Employee Stock Purchase Plan		10-K	6/30/12	10.4	7/26/12
10.5*	Microsoft Corporation Deferred Compensation Plan		10-Q	3/31/12	10.5	4/19/12
10.7*	Form of Stock Award Agreement for Non-Employee Directors under the Microsoft Corporation 1999 Stock Plan for Non-Employee Directors		10-K	6/30/04	10.9	9/1/04
10.10*	Form of Stock Option Agreement under the Microsoft Corporation 2001 Stock Plan		10-K	6/30/04	10.12	9/1/04
10.11*	Form of Stock Option Agreement for Non-Employee Directors under the 1999 Stock Plan for Non-Employee Directors		10-K	6/30/04	10.13	9/1/04
10.12	2009 Officers Indemnification Trust Agreement between Microsoft Corporation and The Bank of New York Mellon Trust Company, as trustee		10-K	6/30/10	10.12	7/30/10
10.13	Amended and Restated 2003 Indemnification Trust Agreement between Microsoft Corporation and The Bank of New York Mellon Trust Company, as trustee		10-K	6/30/10	10.13	7/30/10
10.14*	Microsoft Corporation Deferred Compensation Plan for Non-Employee Directors		S-8		99.2	2/28/06
10.17*	Executive Officer Incentive Plan		8-K		10.17	9/23/13
10.18*	Form of Executive Incentive Plan Stock Award Agreement under the Microsoft Corporation 2001 Stock Plan		8-K		10.20	9/23/13
10.19*	Resignation Agreement and Full and Final Release of Claims between Microsoft Corporation and Steven Sinofsky		10-K	6/30/13	10.19	7/30/13
10.21	Stock Award Agreement under the Microsoft Corporation 2001 Stock Plan (Service-Based)		8-K		10.21	9/23/13
10.22	Senior Executive Severance Benefit Plan		8-K		10.22	9/26/13

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Exhibit Number	Exhibit Description	Filed Herewith	Incorporated by Reference Form	Period Ending	Exhibit	Filing Date
12	Computation of Ratio of Earnings to Fixed Charges	X				
21	Subsidiaries of Registrant	X				
23.1	Consent of Independent Registered Public Accounting Firm	X				
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X				
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X				
32.1**	Certifications of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X				
32.2**	Certifications of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X				
101.INS	XBRL Instance Document	X				
101.SCH	XBRL Taxonomy Extension Schema	X				
101.CAL	XBRL Taxonomy Extension Calculation Linkbase	X				
101.DEF	XBRL Taxonomy Extension Definition Linkbase	X				
101.LAB	XBRL Taxonomy Extension Label Linkbase	X				
101.PRE	XBRL Taxonomy Extension Presentation Linkbase	X				

* *Indicates a management contract or compensatory plan or arrangement*
** *Furnished, not filed*

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, in the City of Redmond, State of Washington, on July 31, 2014.

MICROSOFT CORPORATION

/s/ FRANK H. BROD
Frank H. Brod
Corporate Vice President, Finance and Administration;

Chief Accounting Officer (Principal Accounting Officer)
Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on July 31, 2014.

Signature	Title
/s/ JOHN W. THOMPSON	Chairman
John W. Thompson	
/s/ SATYA NADELLA	Director and Chief Executive Officer
Satya Nadella	
/s/ STEVEN A. BALLMER	Director
Steven A. Ballmer	
/s/ DINA DUBLON	Director
Dina Dublon	
/s/ WILLIAM H. GATES III	Director
William H. Gates III	
/s/ MARIA M. KLAWE	Director
Maria M. Klawe	
/s/ DAVID F. MARQUARDT	Director
David F. Marquardt	
/s/ G. MASON MORFIT	Director

G. Mason Morfit	
/s/ Charles H. Noski	Director
Charles H. Noski	
/s/ Helmut Panke	Director
Helmut Panke	
/s/ Amy E. Hood	Executive Vice President and Chief Financial Officer
Amy E. Hood	(Principal Financial Officer)
/s/ Frank H. Brod	Corporate Vice President, Finance and Administration;
Frank H. Brod	Chief Accounting Officer
	(Principal Accounting Officer)