MSFT Q2 2022 Management Discussion & Analysis

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

**Note About Forward-Looking Statements**

This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Risk Factors” (Part II, Item 1A of this Form 10-Q). These forward-looking statements generally are identified by the words “believe,” “project,” “expect,” “anticipate,” “estimate,” “intend,” “strategy,” “future,” “opportunity,” “plan,” “may,” “should,” “will,” “would,” “will be,” “will continue,” “will likely result,” and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Quantitative and Qualitative Disclosures about Market Risk” (Part I, Item 3 of this Form 10-Q), and “Risk Factors”. We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our Annual Report on Form 10-K for the year ended June 30, 2021, and our financial statements and the accompanying Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

OVERVIEW

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

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

As the world continues to respond to COVID-19, we are working to do our part by ensuring the safety of our employees, striving to protect the health and well-being of the communities in which we operate, and providing technology and resources to our customers to help them do their best work while remote.

Highlights from the second quarter of fiscal year 2022 compared with the second quarter of fiscal year 2021 included:

|  |  |  |
| --- | --- | --- |
|  | • | Microsoft Cloud (formerly commercial cloud) revenue increased 32% to $22.1 billion. |
|  | • | Office Commercial products and cloud services revenue increased 14% driven by Office 365 Commercial growth of 19%. |

|  |  |  |
| --- | --- | --- |
|  | • | Office Consumer products and cloud services revenue increased 15% and Microsoft 365 Consumer subscribers grew to 56.4 million. |
|  | • | LinkedIn revenue increased 37%. |

|  |  |  |
| --- | --- | --- |
|  | • | Dynamics products and cloud services revenue increased 29% driven by Dynamics 365 growth of 45%. |
|  | • | Server products and cloud services revenue increased 29% driven by Azure and other cloud services growth of 46%. |

|  |  |  |
| --- | --- | --- |
|  | • | Windows original equipment manufacturer licensing (“Windows OEM”) revenue increased 25%. |
|  | • | Windows Commercial products and cloud services revenue increased 13%. |

|  |  |  |
| --- | --- | --- |
|  | • | Xbox content and services revenue increased 10%. |

31

PART I

Item 2

|  |  |  |
| --- | --- | --- |
|  | • | Search and news advertising revenue excluding traffic acquisition costs increased 32%. |
|  | • | Surface revenue increased 8%. |

**Industry Trends**

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

**Economic Conditions, Challenges, and Risks**

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

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

Our devices are primarily manufactured by third-party contract manufacturers, some of which contain certain components for which there are very few qualified suppliers. For these components, we have limited near-term flexibility to use other manufacturers if a current vendor becomes unavailable or is unable to meet our requirements. Extended disruptions at these suppliers could lead to a similar disruption in our ability to manufacture devices on time to meet consumer demand.

Our international operations provide a significant portion of our total revenue and expenses. Many of these revenue and expenses are denominated in currencies other than the U.S. dollar. As a result, changes in foreign exchange rates may significantly affect revenue and expenses. Fluctuations in the U.S. dollar relative to certain foreign currencies did not have a material impact on reported revenue or expenses from our international operations for the three or six months ended December 31, 2021.

Refer to Risk Factors (Part II, Item 1A of this Form 10-Q) for a discussion of these factors and other risks.

**COVID-19**

The COVID-19 pandemic continues to impact our business operations and financial results, although some of the effects have lessened over time. Our commercial and consumer businesses have benefited from demand for cloud and productivity tools, and we have experienced savings in operating expenses related to COVID-19. The COVID-19 pandemic may continue to impact our business operations and financial operating results, and there is uncertainty in the nature and degree of its continued effects over time. Refer to Risk Factors (Part II, Item 1A of this Form 10-Q) for a discussion of these factors and other risks.

**Seasonality**

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

32

PART I

Item 2

**Reportable Segments**

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

Additional information on our reportable segments is contained in Note 17 – Segment Information and Geographic Data of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q).

**Metrics**

We use metrics in assessing the performance of our business and to make informed decisions regarding the allocation of resources. We disclose metrics to enable investors to evaluate progress against our ambitions, provide transparency into performance trends, and reflect the continued evolution of our products and services. Our commercial and other business metrics are fundamentally connected based on how customers use our products and services. The metrics are disclosed in the MD&A or the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q). Financial metrics are calculated based on GAAP results and growth comparisons relate to the corresponding period of last fiscal year.

In the first quarter of fiscal year 2022, we made updates to the presentation and method of calculation for certain metrics, most notably changes to incorporate all current and anticipated revenue streams within our Office Consumer and Server products and cloud services metrics and changes to align with how we manage our Windows OEM and Search and news advertising businesses. None of these changes had a material impact on previously reported amounts in our MD&A.

***Commercial***

Our commercial business primarily consists of Server products and cloud services, Office Commercial, Windows Commercial, the commercial portion of LinkedIn, Enterprise Services, and Dynamics. Our commercial metrics allow management and investors to assess the overall health of our commercial business and include leading indicators of future performance.

|  |  |  |
| --- | --- | --- |
| Commercial remaining performance obligation |  | Commercial portion of revenue allocated to remaining performance obligations, which includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods |
|  |  |  |
| Microsoft Cloud revenue |  | Revenue from our commercial cloud business, which includes Azure and other cloud services, Office 365 Commercial, the commercial portion of LinkedIn, Dynamics 365, and other commercial cloud properties |
|  |  |  |
| Microsoft Cloud gross margin percentage |  | Gross margin percentage for our commercial cloud business |

33

PART I

Item 2

***Productivity and Business Processes and Intelligent Cloud***

Metrics related to our Productivity and Business Processes and Intelligent Cloud segments assess the health of our core businesses within these segments. The metrics reflect our cloud and on-premises product strategies and trends.

|  |  |  |
| --- | --- | --- |
| Office Commercial products and cloud services revenue growth |  | Revenue from Office Commercial products and cloud services (Office 365 subscriptions, the Office 365 portion of Microsoft 365 Commercial subscriptions, and Office licensed on-premises), comprising Office, Exchange, SharePoint, Microsoft Teams, Office 365 Security and Compliance, and Skype for Business |
|  |  |  |
| Office Consumer products and cloud services revenue growth |  | Revenue from Office Consumer products and cloud services, including Microsoft 365 Consumer subscriptions, Office licensed on-premises, and other Office services |
|  |  |  |
| Office 365 Commercial seat growth |  | The number of Office 365 Commercial seats at end of period where seats are paid users covered by an Office 365 Commercial subscription |
|  |  |  |
| Microsoft 365 Consumer subscribers |  | The number of Microsoft 365 Consumer subscribers at end of period |
|  |  |  |
| Dynamics products and cloud services revenue growth |  | Revenue from Dynamics products and cloud services, including Dynamics 365, comprising a set of intelligent, cloud-based applications across ERP, CRM, Customer Insights, Power Apps, and Power Automate; and on-premises ERP and CRM applications |
|  |  |  |
| LinkedIn revenue growth |  | Revenue from LinkedIn, including Talent Solutions, Marketing Solutions, Premium Subscriptions, Sales Solutions, and Learning Solutions |
|  |  |  |
| Server products and cloud services revenue growth |  | Revenue from Server products and cloud services, including Azure and other cloud services; SQL Server, Windows Server, Visual Studio, System Center, and related Client Access Licenses (“CALs”); and GitHub |

***More Personal Computing***

Metrics related to our More Personal Computing segment assess the performance of key lines of business within this segment. These metrics provide strategic product insights which allow us to assess the performance across our commercial and consumer businesses. As we have diversity of target audiences and sales motions within the Windows business, we monitor metrics that are reflective of those varying motions.

|  |  |  |
| --- | --- | --- |
| Windows OEM revenue growth |  | Revenue from sales of Windows Pro and non-Pro licenses sold through the OEM channel |
|  |  |  |
| Windows Commercial products and cloud services revenue growth |  | Revenue from Windows Commercial products and cloud services, comprising volume licensing of the Windows operating system, Windows cloud services, and other Windows commercial offerings |
|  |  |  |
| Surface revenue growth |  | Revenue from Surface devices and accessories |
|  |  |  |
| Xbox content and services revenue growth |  | Revenue from Xbox content and services, comprising digital transactions, Xbox Game Pass and other subscriptions, video games, third-party video game royalties, cloud services, and advertising |
|  |  |  |
| Search and news advertising revenue, excluding TAC, growth |  | Revenue from search and news advertising excluding traffic acquisition costs (“TAC”) paid to Bing Ads network publishers and news partners |

34

PART I

Item 2

SUMMARY RESULTS OF OPERATIONS

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except percentages and per share amounts)** |  |  | **Three Months Ended**  **December 31,** | | | | |  |  | **Percentage**  **Change** | |  |  | **Six Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | **2021** |  |  |  | **2020** |  |  |  |  |  |  |  | **2021** |  |  |  | **2020** |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Revenue |  | **$** | **51,728** |  |  | $ | 43,076 |  |  |  | 20% |  |  | **$** | **97,045** |  |  | $ | 80,230 |  |  |  | 21% |  |
| Gross margin |  |  | **34,768** |  |  |  | 28,882 |  |  |  | 20% |  |  |  | **66,439** |  |  |  | 55,034 |  |  |  | 21% |  |
| Operating income |  |  | **22,247** |  |  |  | 17,897 |  |  |  | 24% |  |  |  | **42,485** |  |  |  | 33,773 |  |  |  | 26% |  |
| Net income |  |  | **18,765** |  |  |  | 15,463 |  |  |  | 21% |  |  |  | **39,270** |  |  |  | 29,356 |  |  |  | 34% |  |
| Diluted earnings per share |  |  | **2.48** |  |  |  | 2.03 |  |  |  | 22% |  |  |  | **5.19** |  |  |  | 3.85 |  |  |  | 35% |  |
| Adjusted net income (non-GAAP) |  |  | **18,765** |  |  |  | 15,463 |  |  |  | 21% |  |  |  | **35,979** |  |  |  | 29,356 |  |  |  | 23% |  |
| Adjusted diluted earnings per share (non-GAAP) |  |  | **2.48** |  |  |  | 2.03 |  |  |  | 22% |  |  |  | **4.76** |  |  |  | 3.85 |  |  |  | 24% |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

Adjusted net income and adjusted diluted earnings per share (“EPS”) are non-GAAP financial measures which exclude the net income tax benefit related to transfer of intangible properties in the first quarter of fiscal year 2022. Refer to the Non-GAAP Financial Measures section below for a reconciliation of our financial results reported in accordance with GAAP to non-GAAP financial results. See Note 11 – Income Taxes of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for further discussion.

***Three Months Ended December 31, 2021 Compared with Three Months Ended December 31, 2020***

Revenue increased $8.7 billion or 20% driven by growth across each of our segments. Intelligent Cloud revenue increased driven by Azure and other cloud services. Productivity and Business Processes revenue increased driven by Office 365 Commercial and LinkedIn. More Personal Computing revenue increased driven by Windows and Search and news advertising.

Cost of revenue increased $2.8 billion or 19% driven by growth in Microsoft Cloud.

Gross margin increased $5.9 billion or 20% driven by growth across each of our segments.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin percentage was relatively unchanged. Excluding the impact of the change in accounting estimate for the useful lives of our server and network equipment, gross margin percentage increased 2 points driven by improvements in More Personal Computing and Productivity and Business Processes. |
|  | • | Microsoft Cloud gross margin percentage decreased slightly to 70%. Excluding the impact of the change in accounting estimate, Microsoft Cloud gross margin percentage increased 3 points driven by improvement across our cloud services, offset in part by sales mix shift to Azure and other cloud services. |

Operating expenses increased $1.5 billion or 14% driven by investments in cloud engineering, Gaming, LinkedIn, and commercial sales.

Key changes in operating expenses were:

|  |  |  |
| --- | --- | --- |
|  | • | Research and development expenses increased $859 million or 18% driven by investments in cloud engineering and Gaming. |
|  | • | Sales and marketing expenses increased $432 million or 9% driven by investments in commercial sales and LinkedIn. |

|  |  |  |
| --- | --- | --- |
|  | • | General and administrative expenses increased $245 million or 22% primarily driven by an increase in headcount. |

Operating income increased $4.4 billion or 24% driven by growth across each of our segments.

35

PART I

Item 2

***Six Months Ended December 31, 2021 Compared with Six Months Ended December 31, 2020***

Revenue increased $16.8 billion or 21% driven by growth across each of our segments. Intelligent Cloud revenue increased driven by Azure and other cloud services. Productivity and Business Processes revenue increased driven by Office 365 Commercial and LinkedIn. More Personal Computing revenue increased driven by Windows, Search and news advertising, and Gaming.

Cost of revenue increased $5.4 billion or 21% driven by growth in Microsoft Cloud and Gaming.

Gross margin increased $11.4 billion or 21% driven by growth across each of our segments.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin percentage was relatively unchanged. Excluding the impact of the change in accounting estimate, gross margin percentage increased 2 points driven by improvements across each of our segments. |
|  | • | Microsoft Cloud gross margin percentage decreased slightly to 70%. Excluding the impact of the change in accounting estimate, Microsoft Cloud gross margin percentage increased 3 points driven by improvement across our cloud services offset in part by sales mix shift to Azure and other cloud services. |

Operating expenses increased $2.7 billion or 13% driven by investments in cloud engineering, Gaming, commercial sales, and LinkedIn.

Key changes in operating expenses were:

|  |  |  |
| --- | --- | --- |
|  | • | Research and development expenses increased $1.5 billion or 16% driven by investments in cloud engineering and Gaming. |
|  | • | Sales and marketing expenses increased $748 million or 8% driven by investments in commercial sales, LinkedIn, and Windows marketing. |

|  |  |  |
| --- | --- | --- |
|  | • | General and administrative expenses increased $413 million or 18% primarily driven by an increase in headcount. |

Operating income increased $8.7 billion or 26%, including a favorable foreign currency impact of 2%, driven by growth across each of our segments.

Current year net income and diluted EPS were positively impacted by the net tax benefit related to the transfer of intangible properties, which resulted in an increase to net income and diluted EPS of $3.3 billion and $0.43, respectively.

SEGMENT RESULTS OF OPERATIONS

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except percentages)** |  | **Three Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |  | **Six Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **2021** | |  |  | **2020** | |  |  |  | |  |  |  | **2021** |  |  |  | **2020** |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Revenue** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Productivity and Business Processes |  | **$** | **15,936** |  |  | $ | 13,353 |  |  |  | 19% |  |  | **$** | **30,975** |  |  | $ | 25,672 |  |  |  | 21% |  |
| Intelligent Cloud |  |  | **18,327** |  |  |  | 14,601 |  |  |  | 26% |  |  |  | **35,291** |  |  |  | 27,587 |  |  |  | 28% |  |
| More Personal Computing |  |  | **17,465** |  |  |  | 15,122 |  |  |  | 15% |  |  |  | **30,779** |  |  |  | 26,971 |  |  |  | 14% |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **51,728** |  |  | $ | 43,076 |  |  |  | 20% |  |  | **$** | **97,045** |  |  | $ | 80,230 |  |  |  | 21% |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Operating Income** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | | | |  | | | | | | | |  |  |  |  |  |  |  |  |  |  |  |  |
| Productivity and Business Processes |  | **$** | **7,688** |  |  | $ | 6,181 |  |  |  | 24% |  |  | **$** | **15,269** |  |  | $ | 11,887 |  |  |  | 28% |  |
| Intelligent Cloud |  |  | **8,197** |  |  |  | 6,492 |  |  |  | 26% |  |  |  | **15,759** |  |  |  | 11,914 |  |  |  | 32% |  |
| More Personal Computing |  |  | **6,362** |  |  |  | 5,224 |  |  |  | 22% |  |  |  | **11,457** |  |  |  | 9,972 |  |  |  | 15% |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **22,247** |  |  | $ | 17,897 |  |  |  | 24% |  |  | **$** | **42,485** |  |  | $ | 33,773 |  |  |  | 26% |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

36

PART I

Item 2

**Reportable Segments**

***Three Months Ended December 31, 2021 Compared with Three Months Ended December 31, 2020***

*Productivity and Business Processes*

Revenue increased $2.6 billion or 19%.

|  |  |  |
| --- | --- | --- |
|  | • | Office Commercial products and cloud services revenue increased $1.1 billion or 14%. Office 365 Commercial revenue grew 19% driven by seat growth of 16%, with continued momentum in small and medium business and frontline worker offerings, and growth in revenue per user. Office Commercial products revenue declined 17% driven by continued customer shift to cloud offerings, on a low prior year comparable impacted by a slowdown in transactional licensing. |
|  | • | Office Consumer products and cloud services revenue increased $220 million or 15% driven by Microsoft 365 Consumer subscription revenue. Microsoft 365 Consumer subscribers grew 19% to 56.4 million. |

|  |  |  |
| --- | --- | --- |
|  | • | LinkedIn revenue increased $954 million or 37% driven by advertising demand in our Marketing Solutions business and an improving job market in our Talent Solutions business. |
|  | • | Dynamics products and cloud services revenue increased 29% driven by Dynamics 365 growth of 45%. |

Operating income increased $1.5 billion or 24%.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin increased $2.0 billion or 20% driven by growth in Office 365 Commercial and LinkedIn. Gross margin percentage was relatively unchanged. Excluding the impact of the change in accounting estimate, gross margin percentage increased 2 points driven by improvement across all cloud services. |
|  | • | Operating expenses increased $531 million or 13% driven by investments in cloud engineering and LinkedIn. |

*Intelligent Cloud*

Revenue increased $3.7 billion or 26%.

|  |  |  |
| --- | --- | --- |
|  | • | Server products and cloud services revenue increased $3.6 billion or 29% driven by Azure and other cloud services. Azure and other cloud services revenue grew 46% driven by growth in our consumption-based services. Server products revenue increased 6% driven by hybrid solutions, including Windows Server and SQL Server running in multi-cloud environments. |
|  | • | Enterprise Services revenue increased $128 million or 8% driven by growth in Enterprise Support Services and Microsoft Consulting Services. |

Operating income increased $1.7 billion or 26%.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin increased $2.3 billion or 21% driven by growth in Azure and other cloud services. Gross margin percentage decreased. Excluding the impact of the change in accounting estimate, gross margin percentage increased slightly driven by improvement in Azure and other cloud services, offset in part by sales mix shift to Azure and other cloud services. |
|  | • | Operating expenses increased $569 million or 14% driven by investments in Azure and other cloud services. |

*More Personal Computing*

Revenue increased $2.3 billion or 15%.

|  |  |  |
| --- | --- | --- |
|  | • | Windows revenue increased $1.1 billion or 20% driven by growth in Windows OEM and Windows Commercial. Windows OEM revenue increased 25%, including 6 points of positive impact from the Windows 11 revenue deferral, driven by continued growth in the PC market, particularly in commercial which has higher revenue per license. Windows Commercial products and cloud services revenue increased 13% driven by demand for Microsoft 365. |
|  | • | Search and news advertising revenue increased $678 million or 28%. Search and news advertising revenue excluding traffic acquisition costs increased 32% driven by higher revenue per search. |

37

PART I

Item 2

|  |  |  |
| --- | --- | --- |
|  | • | Gaming revenue increased $411 million or 8% on a strong prior year comparable that benefited from Xbox Series X|S launches and stay-at-home scenarios, driven by growth in Xbox content and services. Xbox content and services revenue increased 10% driven by growth in first-party titles and Xbox Game Pass subscriptions, offset in part by a decline in third-party titles. Xbox hardware revenue increased 4% due to continued demand for Xbox Series X|S. |
|  | • | Surface revenue increased $162 million or 8% driven by Surface Laptop. |

Operating income increased $1.1 billion or 22%.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin increased $1.6 billion or 20% driven by growth in Windows and Search and news advertising. Gross margin percentage increased driven by sales mix shift to higher margin businesses and improvement in Search and news advertising. |
|  | • | Operating expenses increased $436 million or 17% driven by investments in Gaming, Search and news advertising, and Windows marketing. |

***Six Months Ended December 31, 2021 Compared with Six Months Ended December 31, 2020***

*Productivity and Business Processes*

Revenue increased $5.3 billion or 21%.

|  |  |  |
| --- | --- | --- |
|  | • | Office Commercial products and cloud services revenue increased $2.5 billion or 16%. Office 365 Commercial revenue grew 21% driven by seat growth of 16%, with continued momentum in small and medium business and frontline worker offerings, and growth in revenue per user. Office Commercial products revenue declined 15% driven by continued customer shift to cloud offerings, on a low prior year comparable impacted by a slowdown in transactional licensing. |
|  | • | Office Consumer products and cloud services revenue increased $355 million or 13% driven by Microsoft 365 Consumer subscription revenue. |

|  |  |  |
| --- | --- | --- |
|  | • | LinkedIn revenue increased $1.9 billion or 39% driven by advertising demand in our Marketing Solutions business and an improving job market in our Talent Solutions business. |
|  | • | Dynamics products and cloud services revenue increased 30% driven by Dynamics 365 growth of 46%. |

Operating income increased $3.4 billion or 28%, including a favorable foreign currency impact of 2%.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin increased $4.2 billion or 21% driven by growth in Office 365 Commercial and LinkedIn. Gross margin percentage was relatively unchanged. Excluding the impact of the change in accounting estimate, gross margin percentage increased 2 points driven by improvement across all cloud services. |
|  | • | Operating expenses increased $821 million or 10% driven by investments in cloud engineering and LinkedIn. |

*Intelligent Cloud*

Revenue increased $7.7 billion or 28%.

|  |  |  |
| --- | --- | --- |
|  | • | Server products and cloud services revenue increased $7.5 billion or 31% driven by Azure and other cloud services. Azure and other cloud services revenue grew 48% driven by growth in our consumption-based services. Server products revenue increased 10% driven by hybrid solutions, including Windows Server and SQL Server running in multi-cloud environments, on a low prior year comparable impacted by a slowdown in transactional licensing. |
|  | • | Enterprise Services revenue increased $282 million or 8% driven by growth in Microsoft Consulting Services and Enterprise Support Services. |

38

PART I

Item 2

Operating income increased $3.8 billion or 32%.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin increased $4.9 billion or 25% driven by growth in Azure and other cloud services. Gross margin percentage decreased. Excluding the impact of the change in accounting estimate, gross margin percentage increased 1 point driven by improvement in Azure and other cloud services, offset in part by sales mix shift to Azure and other cloud services. |
|  | • | Operating expenses increased $1.1 billion or 13% driven by investments in Azure and other cloud services. |

*More Personal Computing*

Revenue increased $3.8 billion or 14%.

|  |  |  |
| --- | --- | --- |
|  | • | Windows revenue increased $1.6 billion or 15% driven by growth in Windows OEM and Windows Commercial. Windows OEM revenue increased 18% driven by continued growth in the PC market, particularly in commercial which has higher revenue per license. Windows Commercial products and cloud services revenue increased 13% driven by demand for Microsoft 365. |
|  | • | Search and news advertising revenue increased $1.4 billion or 32%. Search and news advertising revenue excluding traffic acquisition costs increased 36% driven by higher revenue per search, on a low prior year comparable. |

|  |  |  |
| --- | --- | --- |
|  | • | Gaming revenue increased $912 million or 11% on a strong prior year comparable that benefited from Xbox Series X|S launches and stay-at-home scenarios, driven by growth in Xbox hardware and Xbox content and services. Xbox hardware revenue increased 28% driven by higher volume of consoles sold due to continued demand for Xbox Series X|S. Xbox content and services revenue increased 6% driven by growth in first-party titles and Xbox Game Pass subscriptions, offset in part by a decline in third-party titles. |
|  | • | Surface revenue decreased $105 million or 3% on a strong prior year comparable. |

Operating income increased $1.5 billion or 15%.

|  |  |  |
| --- | --- | --- |
|  | • | Gross margin increased $2.3 billion or 15% driven by growth in Windows and Search and news advertising. Gross margin percentage increased slightly driven by sales mix shift to higher margin businesses and improvement in Search and news advertising. |
|  | • | Operating expenses increased $807 million or 16% driven by investments in Gaming, Windows marketing, and Search and news advertising. |

OPERATING EXPENSES

**Research and Development**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except percentages)** |  | **Three Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |  | **Six Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **2021** | |  |  | **2020** | |  |  |  | |  |  |  | **2021** |  |  |  | **2020** |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Research and development |  | **$** | **5,758** |  |  | $ | 4,899 |  |  |  | 18% |  |  | **$** | **11,357** |  |  | $ | 9,825 |  |  |  | 16% |  |
| As a percent of revenue |  |  | **11%** |  |  |  | 11% |  |  |  | 0ppt |  |  |  | **12%** |  |  |  | 12% |  |  |  | 0ppt |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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

***Three Months Ended December 31, 2021 Compared with Three Months Ended December 31, 2020***

Research and development expenses increased $859 million or 18% driven by investments in cloud engineering and Gaming.

39

PART I

Item 2

***Six Months Ended December 31, 2021 Compared with Six Months Ended December 31, 2020***

Research and development expenses increased $1.5 billion or 16% driven by investments in cloud engineering and Gaming.

**Sales and Marketing**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except percentages)** |  | **Three Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |  | **Six Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **2021** | |  |  | **2020** | |  |  |  | |  |  |  | **2021** |  |  |  | **2020** |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Sales and marketing |  | **$** | **5,379** |  |  | $ | 4,947 |  |  |  | 9% |  |  | **$** | **9,926** |  |  | **$** | 9,178 |  |  |  | 8% |  |
| As a percent of revenue |  |  | **10%** |  |  |  | 11% |  |  |  | (1)ppt |  |  |  | **10%** |  |  |  | 11% |  |  |  | (1)ppt |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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

***Three Months Ended December 31, 2021 Compared with Three Months Ended December 31, 2020***

Sales and marketing expenses increased $432 million or 9% driven by investments in commercial sales and LinkedIn.

***Six Months Ended December 31, 2021 Compared with Six Months Ended December 31, 2020***

Sales and marketing expenses increased $748 million or 8% driven by investments in commercial sales, LinkedIn, and Windows marketing.

**General and Administrative**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions, except percentages)** |  | **Three Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |  | **Six Months Ended**  **December 31,** | | | | | |  |  | **Percentage**  **Change** | |  |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | | | | | |  |  |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **2021** | |  |  | **2020** | |  |  |  | |  |  |  | **2021** |  |  |  | **2020** |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| General and administrative |  | **$** | **1,384** |  |  | $ | 1,139 |  |  |  | 22% |  |  | **$** | **2,671** |  |  | $ | 2,258 |  |  |  | 18% |  |  |
| As a percent of revenue |  |  | **3%** |  |  |  | 3% |  |  |  | 0ppt |  |  |  | **3%** |  |  |  | 3% |  |  |  | 0ppt |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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

***Three Months Ended December 31, 2021 Compared with Three Months Ended December 31, 2020***

General and administrative expenses increased $245 million or 22% primarily driven by an increase in headcount.

***Six Months Ended December 31, 2021 Compared with Six Months Ended December 31, 2020***

General and administrative expenses increased $413 million or 18% primarily driven by an increase in headcount.

40

PART I

Item 2

OTHER INCOME (EXPENSE), NET

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

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **(In millions)** |  | **Three Months Ended**  **December 31,** | | | | | |  |  |  | **Six Months Ended**  **December 31,** | | | | |  |
|  |  |  | |  |  |  | |  |  |  |  |  |  |  |  |  |
|  |  |  | |  |  |  | |  |  |  |  |  |  |  |  |  |
|  |  | **2021** | |  |  | **2020** | |  |  |  | **2021** |  |  |  | **2020** |  |
|  |  | | | |  |  |  |  |  |  |  |  |  |  |  |  |
| Interest and dividends income |  | **$** | **503** |  |  | $ | 545 |  |  | **$** | **1,023** |  |  | $ | 1,115 |  |
| Interest expense |  |  | **(525** | **)** |  |  | (571 | ) |  |  | **(1,064** | **)** |  |  | (1,160 | ) |
| Net recognized gains on investments |  |  | **300** |  |  |  | 359 |  |  |  | **671** |  |  |  | 484 |  |
| Net gains (losses) on derivatives |  |  | **7** |  |  |  | (5 | ) |  |  | **0** |  |  |  | (2 | ) |
| Net gains (losses) on foreign currency remeasurements |  |  | **(13** | **)** |  |  | 42 |  |  |  | **(78** | **)** |  |  | 181 |  |
| Other, net |  |  | **(4** | **)** |  |  | 70 |  |  |  | **2** |  |  |  | 70 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total |  | **$** | **268** |  |  | $ | 440 |  |  | **$** | **554** |  |  | $ | 688 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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 hedging instruments are primarily recognized in other income (expense), net.

***Three Months Ended December 31, 2021 Compared with Three Months Ended December 31, 2020***

Interest and dividends income decreased due to lower portfolio balances. Interest expense decreased due to a decrease in outstanding long-term debt due to debt maturities. Net recognized gains on investments decreased due to lower gains on equity securities.

***Six Months Ended December 31, 2021 Compared with Six Months Ended December 31, 2020***

Interest and dividends income decreased due to lower portfolio balances. Interest expense decreased due to a decrease in outstanding long-term debt due to debt maturities. Net recognized gains on investments increased due to higher gains on equity securities.

INCOME TAXES

**Effective Tax Rate**

Our effective tax rate was 17% and 16% for the three months ended December 31, 2021 and 2020, respectively, and 9% and 15% for the six months ended December 31, 2021 and 2020, respectively. The increase in our effective tax rate for the three months ended December 31, 2021 compared to the prior year was primarily due to changes in the mix of our income before income taxes between the U.S. and foreign countries and tax benefits from final Tax Cuts and Jobs Act (“TCJA”) regulations in fiscal year 2021, offset in part by an increase in tax benefits relating to stock-based compensation. The decrease in our effective tax rate for the six months ended December 31, 2021 compared to the prior year was primarily due to a $3.3 billion net income tax benefit in the first quarter of fiscal year 2022 related to the transfer of intangible properties.

In the first quarter of fiscal year 2022, we transferred certain intangible properties from our Puerto Rico subsidiary to the U.S. The transfer of intangible properties resulted in a $3.3 billion net income tax benefit in the first quarter of fiscal year 2022, as the value of future U.S. tax deductions exceeds the current tax liability from the U.S. global intangible low-taxed income tax.

Our effective tax rate was lower than the U.S. federal statutory rate for the three and six months ended December 31, 2021, 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 center in Ireland, tax benefits relating to stock-based compensation, and for the six months ended December 31, 2021, the net income tax benefit related to the transfer of intangible properties.

41

PART I

Item 2

**Uncertain Tax Positions**

We settled a portion of the Internal Revenue Service (“IRS”) audit for tax years 2004 to 2006 in fiscal year 2011. In February 2012, the IRS withdrew its 2011 Revenue Agents Report related to unresolved issues for tax years 2004 to 2006 and reopened the audit phase of the examination. We also settled a portion of the IRS audit for tax years 2007 to 2009 in fiscal year 2016, and a portion of the IRS audit for tax years 2010 to 2013 in fiscal year 2018. In the second quarter of fiscal year 2021, we settled an additional portion of the IRS audits for tax years 2004 to 2013 and made a payment of $1.7 billion, including tax and interest. We remain under audit for tax years 2004 to 2017.

As of December 31, 2021, the primary unresolved issues for the IRS audits relate to transfer pricing, which could have a material impact in our consolidated financial statements when the matters are resolved. We believe our allowances for income tax contingencies are adequate. We have not received a proposed assessment for the unresolved key transfer pricing issues and do not expect a final resolution of these issues in the next 12 months. Based on the information currently available, we do not anticipate a significant increase or decrease to our tax contingencies for these issues within the next 12 months.

We are subject to income tax in many jurisdictions outside the U.S. Our operations in certain jurisdictions remain subject to examination for tax years 1996 to 2021, some of which are currently under audit by local tax authorities. The resolution of each of these audits is not expected to be material to our consolidated financial statements.

**Cash Flows**

Cash from operations increased $7.2 billion to $39.0 billion for the six months ended December 31, 2021, mainly due to an increase in cash received from customers, offset in part by an increase in cash paid to employees and suppliers. Cash used in financing increased $4.3 billion to $28.3 billion for the six months ended December 31, 2021, mainly due to a $1.8 billion increase in common stock repurchases and a $1.6 billion increase in repayments of debt. Cash used in investing decreased $2.6 billion to $4.4 billion for the six months ended December 31, 2021, mainly due to a $5.1 billion increase in cash from net investment purchases, sales, and maturities and a $1.3 billion decrease in other investing to facilitate the purchase of components, offset in part by a $2.6 billion increase in additions to property and equipment and a $1.2 billion increase in cash used for acquisitions of companies, net of cash acquired, and purchases of intangible and other assets.

**Other Planned Uses of Capital**

On January 18, 2022, we entered into a definitive agreement to acquire Activision Blizzard, Inc. (“Activision Blizzard”) for $95.00 per share in an all-cash transaction valued at $68.7 billion, inclusive of Activision Blizzard’s net cash. We expect this acquisition to close in fiscal year 2023, subject to approval by Activision Blizzard’s shareholders, the satisfaction of certain regulatory approvals, and other customary closing conditions.

On April 11, 2021, we entered into a definitive agreement to acquire Nuance Communications, Inc. (“Nuance”) for $56.00 per share in an all-cash transaction valued at $19.7 billion, inclusive of Nuance’s net debt. The acquisition has been approved by Nuance’s shareholders, and we expect it to close in the third quarter of fiscal year 2022, subject to the satisfaction of certain regulatory approvals and other customary closing conditions.

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

**Liquidity**

As a result of the TCJA, we are required to pay a one-time transition tax on deferred foreign income not previously subject to U.S. income tax. Under the TCJA, the transition tax is payable in interest-free installments over eight years, with 8% due in each of the first five years, 15% in year six, 20% in year seven, and 25% in year eight. We have paid transition tax of $6.2 billion, which included $1.5 billion during the six months ended December 31, 2021. The remaining transition tax of $12.0 billion is payable over the next four years with a final payment in fiscal year 2026.

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