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 December 31, 1998

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period From _____ to ____

Commission File Number 0-14278

MICROSOFT CORPORATION

(Exact name of registrant as specified in its charter)

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

Registrant's telephone number, including area code: (425) 882-8080

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

The number of shares outstanding of the registrant's common stock as of January 29, 1999 was 2,523,459,482.

MICROSOFT CORPORATION

FORM 10-Q

For the Quarter Ended December 31, 1998

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Part I. Financial Information

Item 1. Financial Statements

MICROSOFT CORPORATION

Income Statements
(In millions, except earnings per share)(Unaudited)

	Three Months Ended Dec. 31		Six Months Ended Dec. 31	
	1997	1998	1997	1998
Revenue	$3,585	$4,938	$6,715	$8,891
Operating expenses:				
Cost of revenue	313	433	566	740
Research and development	627	667	1,194	1,278
Acquired in-process technology	0	0	296	0
Sales and marketing	876	940	1,664	1,770
General and administrative	106	149	201	248
Other expenses	50	35	121	59
Total operating expenses	1,972	2,224	4,042	4,095
Operating income	1,613	2,714	2,673	4,796
Investment income	157	337	299	598
Gain on sale	0	0	0	160
Income before income taxes	1,770	3,051	2,972	5,554
Provision for income taxes	637	1,068	1,176	1,888
Net income	$1,133	$1,983	$1,796	$3,666
Earnings per share (1):				
Basic	$ 0.47	$ 0.79	$ 0.74	$ 1.47
Diluted	$ 0.42	$ 0.73	$ 0.67	$ 1.35

(1) Earnings per share amounts for the three and six months ended December 31, 1997 have been restated to reflect a two-for-one stock split in February 1998.

See accompanying notes.

MICROSOFT CORPORATION

Balance Sheets
(In millions)

	June 30 1998	Dec. 31 1998 (1)
Assets		
Current assets:		
Cash and short-term investments	$13,927	$19,237
Accounts receivable	1,460	2,029
Other	502	543
Total current assets	15,889	21,809
Property and equipment	1,505	1,495
Equity investments	4,703	6,262
Other assets	260	483
Total assets	$22,357	$30,049
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 759	$ 989
Accrued compensation	359	392
Income taxes payable	915	1,642
Unearned revenue	2,888	3,552
Other	809	896
Total current liabilities	5,730	7,471
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock - shares authorized 100; outstanding 13	980	980
Common stock and paid-in capital - shares authorized 4,000; outstanding 2,470 and 2,510	8,025	10,443
Retained earnings	7,622	11,155
Total stockholders' equity	16,627	22,578
Total liabilities and stockholders' equity	$22,357	$30,049

(1) Unaudited

See accompanying notes.

MICROSOFT CORPORATION

Cash Flows Statements
(In millions)(Unaudited)

	Six Months Ended Dec. 31 1997	1998
Operations		
Net income	$ 1,796	$ 3,666
Depreciation and amortization	497	356
Write-off of acquired in-process technology	296	0
Gain on sale	0	(160)
Unearned revenue	1,254	2,371
Recognition of unearned revenue from prior periods	(634)	(1,707)
Other current liabilities	297	719
Accounts receivable	(129)	(486)
Other current assets	(33)	(24)
Net cash from operations	3,344	4,735
Financing		
Common stock issued	328	614
Common stock repurchased	(1,596)	(772)
Put warrant proceeds	325	355
Preferred stock dividends	(14)	(14)
Stock option income tax benefits	407	1,218
Net cash from (used for) financing	(550)	1,401
Investments		
Additions to property and equipment	(268)	(241)
Cash portion of WebTV purchase price	(190)	0
Cash proceeds from sale of Softimage	0	79
Equity investments and other	(1,164)	(765)
Short-term investments	(2,263)	(2,993)
Net cash used for investments	(3,885)	(3,920)
Net change in cash and equivalents	(1,091)	2,216
Effect of exchange rates on cash and equivalents	(33)	58
Cash and equivalents, beginning of period	3,706	3,839
Cash and equivalents, end of period	2,582	6,113
Short-term investments, end of period	7,523	13,124
Cash and short-term investments, end of period	$10,105	$19,237

See accompanying notes.

MICROSOFT CORPORATION

Stockholders' Equity Statements
(In millions)(Unaudited)

	Three Months Ended Dec. 31 1997	Three Months Ended Dec. 31 1998	Six Months Ended Dec. 31 1997	Six Months Ended Dec. 31 1998
Convertible preferred stock				
Balance	$ 980	$ 980	$ 980	$ 980
Common stock and paid-in capital				
Balance, beginning of period	5,630	9,161	4,509	8,025
Common stock issued	100	536	626	870
Common stock repurchased	(41)	(11)	(91)	(25)
Structured repurchases price differential	162	0	328	0
Proceeds from sale of put warrants	45	130	325	355
Stock option income tax benefits	208	627	407	1,218
Balance, end of period	6,104	10,443	6,104	10,443
Retained earnings				
Balance, beginning of period	4,854	8,983	5,288	7,622
Net income	1,133	1,983	1,796	3,666
Net unrealized investments gains	74	390	130	540
Translation adjustments and other	10	63	(107)	106
Comprehensive income	1,217	2,436	1,819	4,312
Preferred stock dividends	(7)	(7)	(14)	(14)
Common stock repurchased	(804)	(257)	(1,833)	(765)
Balance, end of period	5,260	11,155	5,260	11,155
Total stockholders' equity	$12,344	$22,578	$12,344	$22,578

See accompanying notes.

Notes to Financial Statements
(Unaudited)

Basis of Presentation

In the opinion of management, the accompanying balance sheets and related interim statements of income, cash flows, and stockholders' equity include all adjustments (consisting only of normal recurring items) necessary for their fair presentation in conformity with generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and bad debts and the length of product life cycles and buildings' lives. Actual results may differ from these estimates. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Microsoft Corporation 1998 Form 10-K.

Stock Splits

In February 1998, outstanding shares of common stock were split two-for-one. All prior share and per share amounts have been restated to reflect the stock split. On January 25, 1999, the Company announced that its Board of Directors approved a two-for-one stock split effective March 29, 1999 for shareholders of record March 12, 1999. The stock split is subject to shareholder approval of an amendment to the Company's articles of incorporation to increase the Company's authorized common stock. Share and per share amounts have not been restated for the upcoming stock split.

Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding preferred shares using the "if-converted" method, assumed net-share settlement of common stock structured repurchases, and outstanding stock options using the "treasury stock" method.

The components of basic and diluted earnings per share were as follows:

Earnings Per Share
(In millions, except earnings per share)

	Three Months Ended Dec. 31		Six Months Ended Dec. 31	
	1997	1998	1997	1998
Net income (A)	$1,133	$1,983	$1,796	$3,666
Preferred stock dividends	(7)	(7)	(14)	(14)
Net income available for common shareholders (B)	$1,126	$1,976	$1,782	$3,652
Average outstanding shares of common stock (C)	2,421	2,499	2,416	2,489
Dilutive effect of:				
Common stock under structured repurchases	0	11	0	10
Preferred stock	19	10	19	11
Employee stock options	227	210	231	214
Common stock and common stock equivalents (D)	2,667	2,730	2,666	2,724
Earnings per share:				
Basic (B/C)	$ 0.47	$ 0.79	$ 0.74	$ 1.47
Diluted (A/D)	$ 0.42	$ 0.73	$ 0.67	$ 1.35

Unearned Revenue

A portion of Microsoft's revenue is earned ratably over the product life cycle or, in the case of subscriptions, over the period of the license agreement.

End-users receive certain elements of the Company's platform products over a period of time. These elements include browser and other Internet technologies, telephone support, Internet-based technical support, service releases, and new device drivers. Consequently, Microsoft recognizes the fair value of these elements, currently approximately 20% of Windows 98 and Windows 95 desktop operating systems OEM revenue and approximately 35% of retail version revenue, over the product's life cycle. Approximately 20% of Windows NT Workstation and Windows NT Server revenue is also recognized ratably. Product life cycles are currently estimated at two years. The Company also sells subscriptions to platforms products via maintenance and certain organizational license agreements. At December 31, 1998, platform products unearned revenue was $1.89 billion.

Likewise, end-users of the Company's applications products receive elements over time, including telephone support, new Internet technologies, and service releases. The fair value of these elements, which is currently approximately 20% of Office 97 applications revenue, is recognized ratably over the estimated 18- month product life cycle. The Company also sells subscriptions to applications and tools products, including maintenance and certain organizational license programs. Unearned revenue associated with applications and tools products totaled $1.57 billion at December 31, 1998.

Unearned revenue associated with other miscellaneous programs totaled $93 million at December 31, 1998.

Stockholders' Equity

Microsoft repurchases its common stock in the open market to provide shares for issuance to employees under stock option and stock purchase plans. During the first half of fiscal 1999, the Company repurchased 7.8 million shares of Microsoft common stock in the open market. In addition, the Company has executed structured repurchases with an independent third party. Under these arrangements, a portion of the purchase price will be paid in the next five or six years and determined based upon the price of Microsoft common stock at that time. The timing and method of payment (net-share or cash) is at the discretion of the Company. The differential between the cash paid and the price of Microsoft common stock on the date of the agreement is reflected in common stock and paid-in capital. During fiscal 1998, 21 million shares were purchased under these arrangements.

To enhance its stock repurchase program, Microsoft sells put warrants to independent third parties. These put warrants entitle the holders to sell shares of Microsoft common stock to the Company on certain dates at specified prices, and permit a net-share settlement at the Company's option. On December 31, 1998, 75 million warrants were outstanding. The outstanding put warrants expire between June 1999 and December 2001 and have strike prices ranging from $87 to $99 per share.

During 1996, Microsoft issued 12.5 million shares of 2.75% convertible exchangeable principal-protected preferred stock. Dividends are payable quarterly in arrears. Preferred shareholders have preference over common stockholders in dividends and liquidation rights. In December 1999, each preferred share is convertible into common shares or an equivalent amount of cash determined by a formula that provides a floor price of $79.875 and a cap of $102.24 per preferred share. Net proceeds of $980 million were used to repurchase common shares.

Acquisitions

In November 1998, Microsoft acquired LinkExchange, Inc., a leading provider of online marketing services to web site owners and small and medium-sized businesses. Microsoft paid $265 million in stock. The Company did not record an in-process technology write-off in connection with the purchase of LinkExchange.

In August 1997, Microsoft acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set- top terminals based on proprietary technologies. Microsoft paid $425 million in stock and cash. The Company recorded an in-process technologies write-off of $296 million in the first quarter of 1998.

Sale of Softimage

In August 1998, the Company sold a wholly-owned subsidiary, Softimage, Inc. to Avid Technology, Inc. Microsoft received cash of $79 million and securities valued at $85 million. A pretax gain of $160 million was recognized in the first quarter of 1999. As part of a transitional service agreement, Microsoft agreed to make certain development tools and management systems available to Avid for use in the Softimage business.

Contingencies

On October 7, 1997, Sun Microsystems, Inc. brought suit against Microsoft in the U.S. District Court for the Northern District of California. Sun's Complaint alleges several claims against Microsoft, all related to the parties' relationship under a March 11, 1996 Technology License and Distribution Agreement (Agreement) concerning certain Java programming language technology. The Complaint seeks: a preliminary and permanent injunction against Microsoft distributing certain products with the Java Compatibility logo, and against distributing Internet Explorer 4.0 unless certain alleged obligations are met; an order compelling Microsoft to perform certain alleged obligations; an accounting; termination of the Agreement; and an award of damages, including compensatory, exemplary and punitive damages, and liquidated damages of $35 million for the alleged source code disclosure.

On March 24, 1998, the court entered an order enjoining Microsoft from using the Java Compatibility logo on Internet Explorer 4.0 and the Microsoft Software Developers Kit for Java 2.0. Microsoft has taken steps to fully comply with the order.

On May 12, 1998, Sun filed companion motions seeking a preliminary injunction based on allegations of copyright infringement and unfair competition. Sun requested an order enjoining Microsoft from distributing any Java-based technology in any operating system, browser, or developers tools, including Windows 98, Internet Explorer 4.0 software, and the Visual J++(TM) 6.0 development system for Java, unless and until Microsoft includes with each such product an implementation of the Java run-time environment that passes Sun's compatibility test suite or an operable implementation of Sun's current Java run-time environment. Hearings on these motions were held in September 1998.

On November 17, 1998, the court entered an order granting Sun's request for a preliminary injunction, holding that Sun had established a likelihood of success on its copyright infringement claims because Microsoft's use of Sun's technology in its products was beyond the scope of the parties' license agreement. The court ordered Microsoft to make certain changes in its products that include Sun's Java Technology and to make certain changes in its Java software development tools. The court also enjoined Microsoft from entering into any licensing agreements that were conditioned on exclusive use of Microsoft's Java Virtual Machine. Microsoft appealed that ruling to the 9th Circuit on December 16, 1998. In the interim, Microsoft is complying with the ruling and has not sought a stay of the injunction pending appeal. On December 18, 1998, Microsoft filed a motion requesting an extension of the 90-day compliance period for certain Microsoft products, which was granted in part in January 1999. Microsoft filed a motion on February 5, 1999, seeking clarification of the court's order that Microsoft would not be prevented from engaging in independent development of Java technology under the order. On January 22, 1999, Microsoft and Sun filed a series of summary judgment motions regarding the interpretation of the contract and other issues. The hearing date for those motions is March 12, 1999.

On October 20, 1997, the Antitrust Division of the U.S. Department of Justice (DOJ) filed a Petition for An Order To Show Cause in United States District Court for the District of Columbia. In its petition, the DOJ contends that Microsoft has violated a 1994 consent decree by including Internet Explorer technology in Windows 95, and by preventing OEMs from removing Internet Explorer functionality from versions of Windows 95 the OEMs are licensed to install on computer systems they sell.

On December 11, 1997, the district court entered two orders. In the first order, Judge Thomas Penfield Jackson denied the DOJ's contempt petition, and dismissed the DOJ's request for relief concerning Microsoft's non-disclosure agreements because the DOJ had failed to present evidence that the agreements had interfered with any DOJ investigation. In addition, however, the court ruled that there were disputed issues of fact regarding Microsoft's violation of the consent decree, and concluded that the DOJ was likely to prevail on its claim that a violation had occurred. The court entered a preliminary injunction sua sponte requiring Microsoft not to condition the licensing of Windows 95 or any successor desktop operating system on a computer manufacturer also licensing any Microsoft browser software, including Internet Explorer 3.0 or 4.0. In the second order, the court appointed Harvard Law Professor Lawrence Lessig as a special master, to whom the court delegated the authority to conduct discovery, take evidence, and make proposed findings of fact and conclusions of law on all issues in the case by May 31, 1998.

Microsoft immediately appealed the preliminary injunction to the District of Columbia Circuit Court of Appeals. On May 5, 1998, Microsoft also sought a stay of the District Court's injunction insofar as it applied to Windows 98. On May 12, 1998, the Court of Appeals granted Microsoft's request for a stay. The Court of Appeals issued an opinion on Microsoft's appeal on June 23, 1998. It unanimously reversed the trial court, both as to the entry of the injunction and the reference to the special master. The opinion both cited procedural errors in the issuance of the injunction and errors of substantive law in the interpretation of the consent decree. The court remanded the case to Judge Jackson for further proceedings consistent with the Court's opinion. There has been no further action in that case since the Court of Appeals' decision.

Although the Court of Appeals could have reversed the district court solely on procedural grounds, it chose to address at length the central issue in both the consent decree case and in the new Sherman Act case brought by the DOJ and 20 state Attorneys General: whether Microsoft is unlawfully "tying" a "separate product" known as Microsoft Internet Explorer to the Windows operating system. Two members of the Court rejected the DOJ's main argument that Internet Explorer constitutes a separate product because Microsoft treats it separately in some circumstances. (One judge dissented in part from the reasoning in this part of the opinion.) The Court's discussion of antitrust tying law, although made in the context of the consent decree case, clearly provides guidance on many of the issues raised in the new Sherman Act case.

On May 18, 1998, the DOJ and a group of 20 state Attorneys General filed two antitrust cases against Microsoft in the U.S. District Court for the District of Columbia. The DOJ complaint alleges violations of Sections 1 and 2 of the Sherman Act. The DOJ complaint seeks declaratory relief as to the violations it asserts and preliminary and permanent injunctive relief regarding: the inclusion of Internet browsing software (or other software products) as part of Windows; the terms of agreements regarding non-Microsoft Internet browsing software (or other software products); taking or threatening "action adverse" in consequence of a person's failure to license or distribute Microsoft Internet browsing software (or other software product) or distributing competing products or cooperating with the government; and restrictions on the screens, boot-up sequence, or functions of Microsoft's operating system products. The state Attorneys General allege largely the same claims, and various pendent state claims. The states seek declaratory relief, and preliminary and permanent injunctive relief similar to that sought by the DOJ, together with statutory penalties under the state law claims. The foregoing description is qualified in its entirety by reference to the full text of the complaints and other papers on file in those actions, case numbers 98-1232 and 98-1233.

On May 22, 1998, Judge Jackson consolidated the two actions. The judge granted Microsoft's motion for summary judgment as to the states' monopoly leverage claim, and permitted the remaining claims to proceed to trial. Trial began on October 19, 1998. Microsoft believes the claims are without merit and is defending against them vigorously. In other ongoing investigations, the DOJ and several state Attorneys General have requested information from Microsoft concerning various issues.

Caldera, Inc. filed a lawsuit against Microsoft in July 1996. It alleges Sherman Act violations relating to Microsoft licensing practices of MS-DOS and Windows in the late 80's and early 90's essentially the same complaints that resulted in the 1994 consent decree. Caldera claims to own the rights of Novell, Inc. and Digital Research Inc. relating to DR-DOS and Novell DOS products. It also asserts a claim that Windows 95 is a technological tie of Windows and MS-DOS. Microsoft has filed nine motions for summary judgment seeking dismissal of Caldera's claims. Those motions are scheduled for hearings in April and May 1999. Trial is scheduled for June 1999. Microsoft is vigorously defending the case.

Microsoft is also subject to various legal proceedings and claims that arise in the ordinary course of business.

Management currently believes that resolving these matters will not have a material adverse impact on the Company's financial position or its results of operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

Microsoft develops, manufactures, licenses, and supports a wide range of software products, including scalable operating systems for intelligent devices, personal computers (PCs), and servers; server applications for client/server environments; business and consumer productivity applications; software development tools; and Internet and intranet software and technologies. The Company's interactive efforts include entertainment and information software programs; the MSN(TM) network of Internet products and services; and alliances with companies involved with other forms of digital interactivity. Microsoft also sells personal computer input devices and books, and researches and develops advanced technologies for future software products.

Revenue

Revenue of $4.94 billion in the December quarter of fiscal 1999 increased 38% over the second quarter of fiscal 1998. On a year to date basis, revenue in the first half of fiscal 1999 totaled $8.89 billion, an increase of 32% over the first two quarters of fiscal 1998. Revenue growth reflected the continued adoption of Microsoft(R) Windows(R) 32-bit operating systems and Microsoft Office. Organizational licensing increased substantially, particularly toward the end of the period, coinciding with the end of budget years for the Information Technology (IT) departments of many companies and governmental units. This surge of IT spending on PCs, desktop applications, and server and server applications appears to have been based on pre-Year 2000 "lockdowns" (i.e. customer decisions to refrain from further software purchases until completion of necessary Year 2000 remediation efforts).

Software license volume increases have been the principal factor in Microsoft's revenue growth. The average selling price per license has decreased, primarily because of general shifts in the sales mix from retail packaged products to licensing programs, from new products to product upgrades, and from stand-alone programs to integrated product suites. Average revenue per license from original equipment manufacturer (OEM) licenses and organizational license programs is lower than average revenue per license from retail versions. Likewise, product upgrades have lower prices than new products. Also, prices of integrated suites, such as Microsoft Office and BackOffice, are less than the sum of the prices for the individual programs included in these suites when such programs are licensed separately. An increased percentage of products and programs included elements that were billed but unearned and recognized ratably, such as certain platforms and applications programs, maintenance, and other subscription models. See accompanying notes to financial statements.

Product Groups

Platforms product revenue grew 50% to $2.32 billion in the second quarter. Revenue of $4.25 billion for the first half of fiscal 1999 grew 44% over the first half of fiscal 1998. Windows units licensed through the OEM channel, particularly Windows NT(R) Workstation, increased strongly over the prior year. Organizational licenses of these desktop platforms also contributed to the growth. Retail versions of Windows 98, which was released in June 1998, contributed to growth, particularly in the first quarter. Windows NT Server revenue was quite healthy. Windows CE and WebTV(TM) service continued to show strong revenue growth, although small in amount.

Applications and Tools product revenue increased 27% to $2.15 billion in the December quarter. Revenue for the first two quarters of $3.86 billion grew 24% compared to the comparable period of the prior year. Desktop applications revenue growth was strong, led by Microsoft Office integrated suites, including the Standard, Professional, and Small Business Editions. The primary programs in Microsoft Office are the word processor Microsoft Word, Microsoft Excel spreadsheet, and Microsoft PowerPoint(R) presentation graphics program. Various versions of Office, which are available for Windows and Macintosh operating systems, also include Microsoft Access database management program, Microsoft Outlook(TM) messaging and collaboration client, or other programs. Server applications revenue, principally Microsoft Exchange Server and Microsoft SQL Server(TM), increased strongly over the comparable periods of the prior year. The Visual Studio(R) 6.0 development system, an integrated set of software development tools, was recently released, leading to hearty tools revenue growth.

Interactive Media and Other revenue was $467 million in the December quarter, up 36% from the comparable quarter of fiscal 1998. Revenue from hardware products increased smartly, particularly joysticks and gamepads. Learning and entertainment software revenue was strong, including Microsoft Encarta(R) reference titles, Flight Simulator games, and the Age of Empires(R) game. Revenue from Microsoft Press was relatively flat and online services revenue rose substantially, but from a small base. Interactive Media and Other revenue of $783 million grew 18% over the first half of the prior year. In the first quarter, revenue from Microsoft Press; hardware; and learning and entertainment software was relatively flat compared to the prior year.

Sales Channels

Microsoft distributes its products primarily through OEM licenses, organizational licenses, and retail packaged products. OEM channel revenue represents license fees from original equipment manufacturers who pre-install Microsoft products, primarily on PCs. Microsoft has three major geographic sales and marketing organizations: the South Pacific and Americas Region; the Europe, Middle East, and Africa Region; and the Asia Region. Sales of organizational licenses and packaged products in these channels are primarily to distributors and resellers.

Second quarter revenue from OEMs of $1.80 billion represented an increase of 48% over the comparable quarter of fiscal 1998. OEM revenue of $3.16 billion in the first half of fiscal 1999 increased 44% over the first half of fiscal 1998. Robust PC shipment growth, particularly in the second quarter, coupled with an increased penetration of higher value 32-bit operating systems drove the OEM revenue increase over the prior year.

For the December quarter, revenue in the South Pacific and Americas Region increased 34% to $1.57 billion. Revenue for the first two quarters of fiscal 1999 also grew 32% to $3.01 billion. These high growth rates reflected strong licensing of many products, including Microsoft Office, Windows NT Server, Windows NT Workstation, Windows 98, and server applications. In addition to steady growth in the U.S., revenue increased strongly in Brazil.

In the Europe, Middle East, and Africa Region, second quarter revenue of $1.20 billion was up 37% compared to the second quarter of fiscal 1998. For the first two quarters of fiscal 1999, revenue in the region totaled $2.04 billion, an increase of 31% over the prior year. Organizational licensing of Microsoft Office, Windows NT Server, Windows NT Workstation, and server applications grew strongly when compared to the prior year. Revenue growth continued to be solid in the United Kingdom, France, and Germany, and was particularly high in Sweden.

Revenue in the Asia Region in the December quarter of $373 million increased 14% from the second quarter of the prior year. Revenue increased in Hong Kong, China, and India, but was flat in Japan and Southeast Asia due to economic issues and weak currencies. On a year to date basis, revenue in the Asia Region was $680 million, flat with the comparable period of the prior year. Revenue in the September quarter decreased 11% from the first quarter of the prior year. Revenue was flat in Japan and decreased in Southeast Asia due to economic issues and weak currencies. As discussed below, the strengthening U.S. dollar negatively impacted translated revenue compared to the prior year, particularly in Japan.

Translated international revenue is affected by foreign exchange rates. The impact of foreign exchange rates on second quarter revenue was nominal, as weaknesses in Japanese, Australian, and Southeast Asian currencies versus the U.S. dollar were offset by the relative strength of European currencies. Had the rates from the prior year been in effect in the first quarter, international revenue billed in local currencies would have been $100 million higher, due to weaknesses in currencies versus the U.S. dollar. Certain manufacturing, selling, distribution, and support costs are disbursed in local currencies, and a portion of international revenue is hedged, thus offsetting a portion of the translation exposure.

Operating Expenses, Nonoperating Items, and Income Taxes

Cost of revenue as a percent of revenue was 8.8% in the second quarter, similar to the percent of revenue the prior year. On a year to date basis, the percentage was 8.3%, which also was similar to the percentage the prior year. The trend in mix shift to higher-margin OEM and organizational licenses was offset by greater volumes of lower-margin interactive media products and certain manufacturing costs, including costs of the WebTV service.

Research and development expenses in the second quarter increased 6% over the prior year to $667 million. For the first two quarters, research and development expenses were $1.28 billion, up 7% over the comparable period of the prior year. These increases were driven primarily by higher development headcount-related costs, offset by lower third-party development costs.

In August 1997, the Company acquired WebTV Networks, Inc., an online service that enables consumers to experience the Internet through their televisions via set-top terminals. Microsoft paid $425 million in stock and cash for WebTV. Fiscal 1998 results reflect a one-time write-off of in-process technologies under development by WebTV of $296 million.

Sales and marketing expenses were $940 million in the December quarter, which represented 19.0% of revenue, compared to 24.4% in the second quarter of the prior year. On a year to date basis, sales and marketing expenses were $1.77 billion, which represented 19.9% of revenue, down from 24.8% of revenue for the first two quarters of fiscal 1998. Expenses as a percent of revenue decreased due to lower relative sales expenses, marketing, and support costs.

General and administrative costs were $149 million in the second quarter compared to $106 million in the December quarter of the prior year. First half general and administrative costs were $248 million, up 23% from $201 million the prior year. The increases were due, in part, to higher legal costs.

Other expenses include primarily the recognition of Microsoft's share of joint venture activities, including DreamWorks Interactive and the MSNBC cable and online news services.

Second quarter investment income increased to $337 million from $157 million in the second quarter of the prior year. Year to date investment income totaled $598 million in fiscal 1999, compared to $299 million the prior year. The increases were due to the larger investment portfolio generated by cash from operations, coupled with realized gains of $70 million from the sale of certain bond and equity securities in the second quarter.

In August 1998, Microsoft sold its Softimage subsidiary to Avid Technology, Inc. A pretax gain of $160 million was recorded in the first quarter of fiscal 1999.

Excluding the tax impact of the gain on the sale of Softimage, the effective tax rate for fiscal 1999 was 35%, less than the higher effective rate in fiscal 1998 due to a legislative clarification of the foreign sales corporation rules as they apply to software and the nondeductible write-off of WebTV in-process technologies.

Financial Condition

Microsoft's cash and short-term investment portfolio totaled $19.24 billion at December 31, 1998. The portfolio is diversified among security types, industries, and individual issuers. Microsoft's investments are generally liquid and investment grade. The portfolio is invested predominantly in U.S. dollar denominated securities, but also includes foreign currency positions in anticipation of continued international expansion. The portfolio is primarily invested in short-term securities to minimize interest rate risk and facilitate rapid deployment in the event of immediate cash needs.

Microsoft also invests in equity securities, including financial investments and strategic technology companies in many areas.

Microsoft has no material long-term debt and has $100 million of standby multicurrency lines of credit to support foreign currency hedging and cash management. Stockholders' equity at December 31, 1998 was $22.58 billion.

Microsoft will continue to invest in sales, marketing, and product support infrastructure. Additionally, research and development activities will include investments in existing and advanced areas of technology, including using cash to acquire technology and to fund ventures and other strategic opportunities. Additions to property and equipment will continue, including new facilities and computer systems for research and development, sales and marketing, support, and administrative staff. Commitments for constructing new buildings were $330 million on December 31, 1998.

Cash will also be used to repurchase common stock to provide shares for employee stock option and purchase plans. The buyback program has not kept pace with employee stock option grants or exercises. Beginning in fiscal 1990, Microsoft has repurchased 355 million common shares while 853 million shares were issued under the Company's employee stock option and purchase plans. The market value of all outstanding stock options was $60 billion as of December 31, 1998. Microsoft enhances its repurchase program by selling put warrants. During December 1996, Microsoft issued 12.5 million shares of 2.75% convertible preferred stock. Net proceeds of $980 million were used to repurchase common shares.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet operating requirements for the next 12 months. Microsoft's cash and short-term investments are available for strategic investments, mergers and acquisitions, other potential large-scale cash needs that may arise, and to fund an increased stock buyback program over historical levels to reduce the dilutive impact of the Company's employee stock option and purchase programs.

Microsoft has not paid cash dividends on its common stock. The preferred stock pays $2.196 per annum per share.

Year 2000

The Year 2000 presents concerns for business and consumer computing. Aside from the well-known problems with the use of certain 2-digit date formats as the year changes from 1999 to 2000, the Year 2000 is a special case leap year, and dates such as 9/9/99 were used by certain organizations for special functions. The problem exists for many kinds of software and hardware, including mainframes, mini-computers, PCs, and embedded systems.

Microsoft offers a broad range of information resources and software updates to help customers plan and implement Year 2000 remediation programs. Current information about the Company's products and business and technical issues is available at the Microsoft Year 2000 Readiness Disclosure and Resource Center web site (www.microsoft.com/year2000). Information on the web site will help customers evaluate the impact of the Year 2000 on Microsoft products used in their computing environments.

The Company is continuing to test its products and classify its tested products into the following categories of compliance: "compliant," "compliant with minor issues," and "not compliant." Most of the products tested are either "compliant" or "compliant with minor issues," as defined. Microsoft's policy is to make future and current versions of its core products Year 2000 "compliant," although the status of certain current versions will remain at "compliant with minor issues." For non-compliant products, Microsoft is providing recommendations as to how an organization may address possible Year 2000 issues regarding that product. Microsoft is issuing software updates (at no additional charge) for most, but not all, known issues. Not all products will be tested.

Information on the Company's web site is provided to customers for the sole purpose of assisting in planning for the transition to the Year 2000. Such information is the most currently available concerning the behavior of the Company's products and is provided "as is" without warranty of any kind. However, variability of definitions of "compliance" with the Year 2000 and of different combinations of software, firmware, and hardware will likely lead to lawsuits against the Company. The outcome of such lawsuits and the impact on the Company are not estimable at this time.

The Year 2000 issue also affects the Company's internal systems, including information technology (IT) and non-IT systems. Microsoft is assessing the readiness of its systems for handling the Year 2000, and has started the remediation and certification process. Contingency plans are being developed in parallel with the testing and remediation efforts.

Microsoft is evaluating its third-party distribution and supply chain to understand their ability to continue providing services and products through the change to the year 2000. Microsoft is monitoring and working directly with key vendors, product manufacturers, distributors, and direct resellers to avoid any business interruptions in the year 2000. For critical third parties with known issues, contingency plans will be developed.

The Company is also reviewing its facilities and infrastructure. Remediation efforts are under way and certain contingency plans are in development.

While Year 2000 issues present a potential risk to Microsoft's internal systems, distribution and supply chain, and facilities, the Company is minimizing risk with a worldwide effort. Microsoft is performing an extensive assessment and is in the process of testing and remediating mission critical components. The current plan is to have the majority of these components resolved by June 1999, with the remaining components resolved by September 1999. Management currently believes that all critical systems will be ready by the Year 2000 and that the cost to address the issues is not material.

Resolving Year 2000 issues is a worldwide phenomenon that will likely absorb a substantial portion of IT budgets and attention in the near term. Certain industry analysts believe the Year 2000 issue will accelerate the trend toward distributed PC-based systems from mainframe systems. Others believe a majority of IT financial resources will be devoted to fixing older mainframe software in lieu of funding purchases of PC software or transitions to systems based on software such as that sold by Microsoft. The impact of the Year 2000 on future Microsoft revenue is difficult to discern but is a risk to be considered in evaluating future growth of the Company.

Part II. Other Information

Item 1. Legal Proceedings

See notes to financial statements.

Item 4. Submission of Matters to a Vote of Security Holders

At the Annual Meeting of Shareholders held on November 11, 1998, the following proposal was adopted by the margins indicated:

To elect a Board of Directors to hold office until their successors are elected and qualified.

	Number of Shares For	Withheld
William H. Gates	2,218,609,523	6,111,854
Paul G. Allen	2,218,316,854	6,404,523
Jill E. Barad	2,218,588,564	6,132,813
Richard A. Hackborn	2,218,701,351	6,020,026
David F. Marquardt	2,218,622,951	6,098,426
William G. Reed, Jr.	2,218,358,703	6,362,674
Jon A. Shirley	2,218,532,388	6,188,989

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

27. Financial Data Schedule

(B) Reports on Form 8-K
Microsoft filed no reports on Form 8-K during the quarter ended December 31, 1998.

Items 2, 3, and 5 are not applicable and have been omitted.

Signature

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

Microsoft Corporation

Date: February 12, 1999 By: /s/ Gregory B. Maffei

Gregory B. Maffei,
Vice President, Finance;
Chief Financial Officer

(Principal Financial and Accounting Officer and Duly Authorized Officer)

ARTICLE 5
THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE ACCOMPANYING FINANCIAL STATEMENTS AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.
MULTIPLIER: 1,000

PERIOD TYPE	6 MOS
FISCAL YEAR END	JUN 30 1999
PERIOD START	JUL 01 1998
PERIOD END	DEC 31 1998
CASH	19,237
SECURITIES	0
RECEIVABLES	2,029
ALLOWANCES	0
INVENTORY	0
CURRENT ASSETS	21,809
PP&E	3,307
DEPRECIATION	1,812
TOTAL ASSETS	30,049
CURRENT LIABILITIES	7,471
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	980
OTHER SE	10,443
TOTAL LIABILITY AND EQUITY	11,155
SALES	30,049
TOTAL REVENUES	8,891
CGS	8,891
TOTAL COSTS	740
OTHER EXPENSES	740
LOSS PROVISION	3,355
INTEREST EXPENSE	0
INCOME PRETAX	0
INCOME TAX	5,554
INCOME CONTINUING	1,888
DISCONTINUED	3,666
EXTRAORDINARY	0
CHANGES	0
NET INCOME	0
EPS PRIMARY	3,666
EPS DILUTED	1.47
	1.35

End of Filing