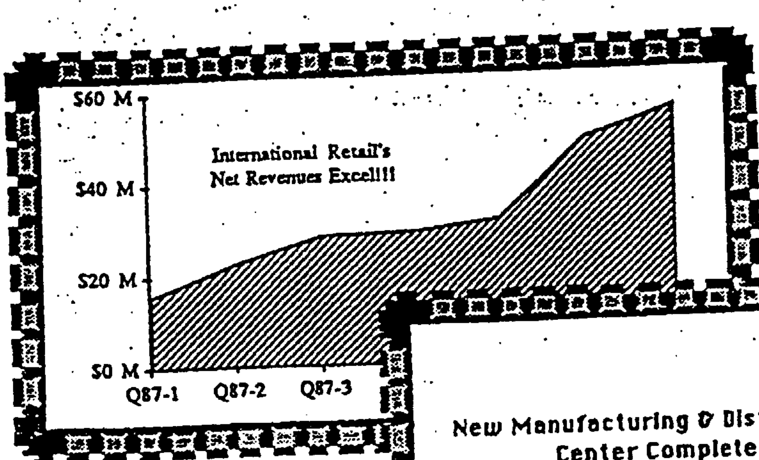
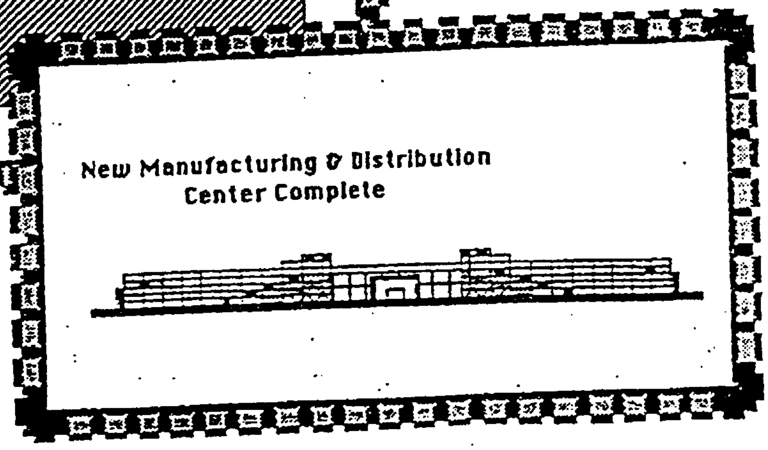
QBB-3

Microsoft®

Steve Gray

Finance and Administration Report
For Quarter Ended March 31, 1988
Board of Directors
April 30, 1988





INDEX

FINANCE

RESULTS OF OPERATIONS
Compared with Prior Year

RESULTS OF OPERATIONS COMPARED WITH PRIOR YEAR

Consolidated statements of income compared with prior year are presented below. The first set is for the three months ended March 31, 1988 and 1987. The second set is for the nine months ended March 31, 1988 and 1987. Amounts are in thousands, except net income per share.

	1988		1987		Change Percentage
Net revenues	$161,823	100.0%	$98,363	100.0%	64.5
Cost and expenses:					
Cost of revenues	41,394	25.6	22,448	22.8	84.4
Research and development	17,739	11.0	10,838	11.0	63.7
Sales and marketing	41,747	25.8	22,013	22.4	89.6
General and administrative	5,738	3.5	5,150	5.3	11.4
Total costs and expenses	106,618	65.9	60,449	61.5	76.4
Income from operations	55,205	34.1	37,914	38.5	45.6
Non-operating income	3,478	2.2	2,276	2.3	52.8
Stock option program expense	(4,036)	(2.5)	(5,820)	(5.9)	(30.7)
Income before income taxes	54,647	33.8	34,370	34.9	59.0
Provision for income taxes	17,339	10.7	15,270	15.5	13.5
NET INCOME	$ 37,308	23.1%	$19,100	19.4%	95.3
Average shares outstanding	55,956		55,082		
NET INCOME PER SHARE	$ .67		$ .35		91.4

	1988		1987		Change Percentage
Net revenues	$420,355	100.0%	$246,128	100.0%	70.8
Cost and expenses:					
Cost of revenues	101,592	24.2	52,647	21.4	93.0
Research and development	48,321	11.5	26,209	10.6	84.4
Sales and marketing	109,449	26.0	57,036	23.2	91.9
General and administrative	17,034	4.1	15,807	6.4	7.8
Total costs and expenses	276,396	65.8	151,699	61.6	82.2
Income from operations	143,959	34.2	94,429	38.4	52.5
Non-operating income	7,731	1.9	6,662	2.7	16.0
Stock option program expense	(10,827)	(2.6)	(5,820)	(2.4)	86.0
Income before income taxes	140,863	33.5	95,271	38.7	47.9
Provision for income taxes	46,967	11.2	40,650	16.5	15.5
NET INCOME	$ 93,896	22.3%	$ 54,621	22.2%	71.9
Average shares outstanding	55,725		55,234		
NET INCOME PER SHARE	$ 1.68		$ .99		69.7

Net revenues for the third quarter of fiscal year 1988 (Q88-3) increased 64.5% to $161.8 million from $98.4 million for the corresponding period of the prior year (Q87-3). As can be seen from the following breakdown of net revenues by Channel of Distribution and Commodity, all channels and all commodities (except Xenix) experienced period-to-period growth.

	Q88-3		Q87-3		Growth Percentage
Channel of Distribution					
USSMD	$ 53,258	32.9%	$33,156	33.7%	60.6
International Retail	55,420	34.3	29,071	29.6	90.6
Worldwide Retail	108,678	67.2	62,227	63.3	74.6
Domestic OEM	25,971	16.1	20,139	20.5	29.0
International OEM	22,196	13.7	13,572	13.8	63.5
Worldwide OEM	48,167	29.8	33,711	34.3	42.9
Press	3,067	1.9	2,425	2.4	26.5
Product Support	1,180	0.7	-	-	-
MS Systems Journal	668	0.4	-	-	-
CD ROM	63	-	-	-	-
CD Consumer	-	-	-	-	-
Total	$161,823	100.0%	$98,363	100.0%	64.5
Commodity					
Applications	$ 63,428	39.2%	$36,648	37.3%	73.1
Systems	55,793	34.5	30,523	31.0	82.8
Languages	15,392	9.5	14,056	14.3	9.5
Hardware	19,226	11.9	11,156	11.3	72.3
Books	3,456	2.1	2,849	2.9	21.6
Xenix	2,873	1.8	3,131	3.2	(8.8)
CD ROM	269	0.2	-	-	-
Network	718	0.4	-	-	-
MS Systems Journal	668	0.4	-	-	-
CD Consumer	-	-	-	-	-
Total	$161,823	100.0%	$98,363	100.0%	64.5

The Company's leading products for the quarter (compared with prior year) were as follows:

			Q88-3		Q87-3	
Q88-3	Q87-3		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	DOS/GW Basic	2,060,221	$ 35,824	1,231,871	$20,969
2	2	Microsoft Mouse	248,670	18,691	101,650	10,826
3	3	PC Word	82,641	16,018	43,146	8,530
4	6	Windows	546,633	11,121	257,107	5,316
5	4	Mac Word	41,669	7,762	38,413	6,121
6	10	Mac Excel	31,629	6,834	9,993	2,225
7	-	PC Excel	26,151	6,641	-	-
8	5	PC Multiplan	54,121	5,520	108,158	5,487
9	7	C Compiler (DOS)	30,525	5,518	15,833	3,681
10	-	PC Word Update	54,723	3,212	15,125	455
11	12	Mac Works	20,873	2,956	13,195	1,892
12	9	Xenix	30,533	2,752	31,185	3,063
13	13	PC Chart	17,200	2,704	13,687	1,847
14	11	Fortran	6,739	2,171	10,920	2,004
15	-	PC Project	7,788	1,744	4,971	1,069
				$129,468		$73,485
Percent of net revenues				80.0%		74.7%

Net revenues for the nine months ended March 31, 1988 increased 70.8% to $420.4 million from $246.1 million for the corresponding period of the prior year. As can be seen from the following breakdown of net revenues by Channel of Distribution and Commodity, all channels and all commodities experienced period-to-period growth.

	1988		1987		Growth Percentage
Channel of Distribution					
USSMD	$137,925	32.8%	$ 85,420	34.7%	61.5
International Retail	136,269	32.4	68,489	27.8	99.0
Worldwide Retail	274,194	65.2	153,909	62.5	78.2
Domestic OEM	79,352	18.9	53,457	21.7	48.4
International OEM	54,500	13.0	33,133	13.5	64.5
Worldwide OEM	133,852	31.9	86,590	35.2	54.6
Press	6,709	1.6	5,616	2.3	19.5
Product Support	3,855	0.9	-	-	-
MS Systems Journal	1,368	0.3	-	-	-
CD ROM	377	0.1	-	-	-
CD Consumer	-	-	13	-	-
Total	$420,355	100.0%	$246,128	100.0%	70.8
Commodity					
Applications	$165,102	39.3%	$92,990	37.8%	77.5
Systems	149,046	35.5	81,843	33.3	82.1
Languages	42,602	10.1	35,748	14.5	19.2
Hardware	44,636	10.6	25,836	10.5	72.8
Books	7,759	1.8	6,570	2.7	18.1
Xenix	6,746	1.6	3,128	1.2	115.7
CD ROM	1,552	0.4	-	-	-
Network	1,545	0.4	-	-	-
MS Systems Journal	1,367	0.3	-	-	-
CD Consumer	-	-	13	-	-
Total	$420,355	100.0%	$246,128	100.0%	70.8

The Company's leading products for the nine months ended March 31, 1988 (compared with prior year) were as follows:

			FY88		FY87	
1988	1987		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	DOS/GW Basic	5,299,012	$ 92,720	2,658,633	$ 49,793
2	2	Microsoft Mouse	531,077	43,434	233,136	24,476
3	3	PC Word	186,656	37,921	125,540	23,354
4	6	Mac Word	148,040	25,430	90,653	11,172
5	5	Windows	1,184,193	24,863	691,641	13,218
6	7	Mac Excel	85,859	17,241	51,985	10,615
7	-	PC Excel	62,702	16,667	-	-
8	4	PC Multiplan	179,717	14,898	262,262	15,057
9	8	C Compiler (DOS)	60,242	12,782	49,267	10,389
10	-	OS/2 SDKs	3,571	8,005	-	-
11	10	Mac Works	54,341	7,794	42,711	6,172
12	9	Xenix	73,394	6,512	59,841	6,456
13	-	PC Word Update	114,606	6,509	63,868	2,158
14	11	PC Chart	38,331	6,449	37,168	5,176
15	-	PC Works	56,333	5,340	-	-
				$326,565		$178,036
		Percent of net revenues		77.7%		72.3%

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Cost of revenues for Q88-3 was 25.6% of net revenues compared with 22.8% for Q87-3. Product costs (material, labor and overhead) as a percentage of net revenues were 19.4% for Q88-3 compared with 14.0% for Q87-3. All other items included in cost of revenues (royalties, inventory valuation adjustments, freight and distribution department expenses) as a percentage of net revenues were 6.2% for Q88-3 compared with 8.8% for Q87-2. The increase product cost results from numerous factors including a shift in the revenue mix to a greater contribution from packaged product (licensing revenue as a percentage of total revenue for Q88-3 was 26.7% compared with 30.1% for Q87-3), a significant increase in update revenues, a deep discount for PC Word that was adopted in Q87-4 and an increase in material costs resulting from the size of the package and dual media. An increase in product returns (with resultant rework or obsolete inventory costs) also contributed to the increase in cost of revenues.

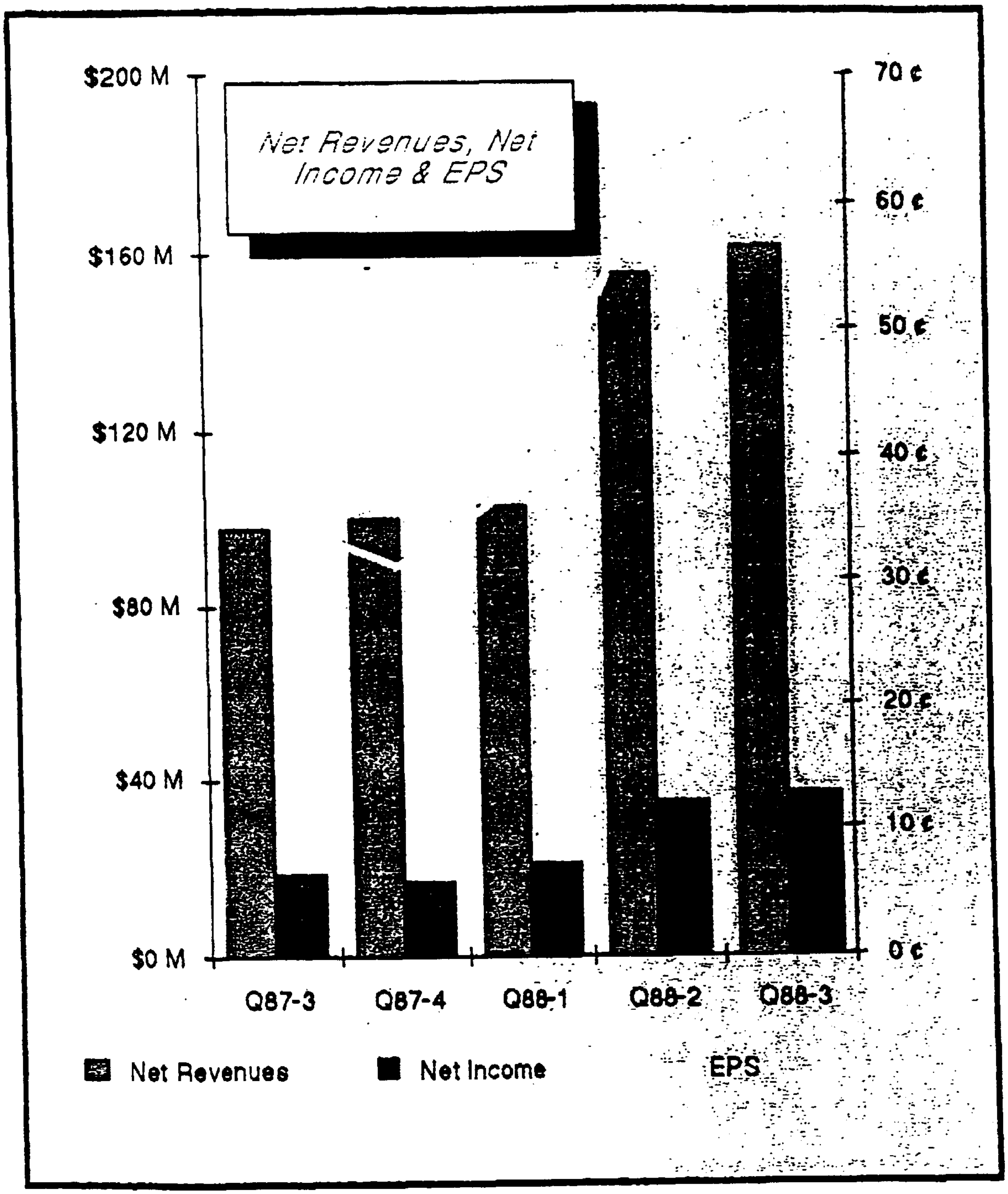
Operating expenses grew 71.6% from period-to-period (to $65.2 million from $38.0 million). The growth in operating expenses exceeded the growth in net revenues (64.5%) and, as such, operating expenses as a percentage of net revenues increased from 38.6% to 40.3%. Categorized in SEC format and expressed as a percentage of net revenues, Sales and Marketing increased from 22.4% to 25.8%, Research and Development was unchanged at 11.0% and General and Administrative decreased from 5.2% to 3.5%. Expense line items with significant period-to-period growth included payroll and payroll taxes (up $7.5 million or 61% to $20.0 million), marketing and advertising (up $6.7 million or 130% to $10.0 million), marketing fund programs (up $2.3 million or 196% to $3.4 million), supplies and equipment (up $2.0 million or 96% to $4.1 million) and third-party product development (up $1.8 million or 75% to $4.2 million). The increase in payroll and payroll taxes tracks fairly closely with the 51% growth in operating headcount (from 1,407 at the end of Q87-3 to 2,119 at the end of Q88-3). Payroll and payroll taxes represent 30.7% of total operating expenses in Q88-3 compared with 32.8% in Q87-3.

Non-operating income for Q88-3 was $3.5 million compared with $2.3 million for Q87-3. Non-operating income for the current quarter consists of investment income of $3.0 million, foreign currency transaction gains of $700,000, and miscellaneous expense of $200,000. Non-operating income for Q87-3 consists of investment income of $1.5 million, foreign currency transaction gains of $1.0 million and miscellaneous expense of $200,000. The growth in investment income is primarily attributed to a larger investment portfolio resulting from funds from operations. The foreign currency transaction gains result from intercompany borrowings pursuant to our hedging program. See discussion of foreign exchange hedging program on page 70.

Stock option program expense is the result of the Company's program regarding incentive stock options under which employees, if they elect to participate, receive a cash payment in exchange for taking certain actions that result in a tax benefit to the Company. Under current accounting rules, the Company reports the gross benefit under the program as a contribution to capital, whereas the expense net of directly related taxes is charged against income. Of the Q88-3 stock option program expense total, $3,036,000 was actually paid out while the other $1.0 million was accrued. Accounting rules require that this expense be recognized ratably over the vesting period of the related options as opposed to being recognized when paid.

The effective tax rates for Q88-3 and Q87-3 were 31.7% and 44.4%, respectively. This decrease in the effective tax rate results from the Tax Reform Act of 1986 which lowered the top corporate tax rate from 46% to 34%.

Net income for Q88-3 was $37.3 million compared with $19.1 million for Q87-3. Net income as a percentage of net revenues increased from 19.4% to 23.1%. Had the stock option program discussed above not been adopted, net income for Q88-3 would have been $40.0 million, 24.7% of net revenues, compared with $22.2 million and 22.6% for Q87-3.



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RESULTS OF OPERATIONS
Compared with Competition

RESULTS OF OPERATIONS COMPARED WITH COMPETITION

Consolidated statements of income for Microsoft, Lotus, and Ashton-Tate are presented below. The first set is for the three months ended March 31, 1988 (January 31, 1988 for Ashton-Tate). The second set is for the twelve months ended March 31, 1988 (January 31, 1988 for Ashton-Tate). Amounts are in thousands, except net income per share.

	Microsoft		Lotus		Ashton-Tate	
Net revenues	$161,823	100.0%	$117,265	100.0%	$75,508	100.0%
Costs and expenses:						
Cost of revenues	41,394	25.6	20,165	17.2	12,755	16.9
Research and development	17,739	11.0	20,071	17.1	8,003	10.6
Sales and marketing	41,747	25.8	40,389	34.4	18,773	24.9
General and administrative	5,738	3.5	12,447	10.5	14,442	19.1
Total costs and expenses	106,618	65.9	93,072	79.4	53,973	71.5
Income from operations	55,205	34.1	24,193	20.6	21,535	28.5
Non-operating income	3,478	2.2	2,015	1.7	1,220	1.6
Stock option program expense	(4,036)	(2.5)	—	—	—	—
Income before income taxes	54,647	33.8	26,208	22.3	22,755	30.1
Provision for income taxes	17,339	10.7	7,862	6.7	10,000	13.2
NET INCOME	$37,308	23.1%	$18,346	15.6%	$12,755	16.9%
Average shares outstanding	55,956		46,353		25,663	
NET INCOME PER SHARE	$ 0.67		$ 0.40		$ 0.50	

	Microsoft		Lotus		Ashton-Tate	
Net revenues	$520,117	100.0%	$428,072	100.0%	$267,328	100.0%
Costs and expenses:						
Cost of revenues	122,799	23.6	72,947	17.0	45,731	17.1
Research and development	60,188	11.6	65,425	15.3	27,985	10.5
Sales and marketing	137,483	26.4	139,843	32.7	63,715	23.8
General and administrative	23,230	4.5	48,997	11.4	56,960	21.3
Total costs and expenses	343,700	66.1	327,212	76.4	194,391	72.7
Income from operations	176,417	33.9	100,860	23.6	72,937	27.3
Non-operating income	9,707	1.9	8,685	2.0	4,039	1.5
Stock option program expense	(19,194)	(3.7)	—	—	—	—
Income before income taxes	166,930	32.1	109,545	25.6	76,976	28.8
Provision for income taxes	55,777	10.7	32,863	7.7	33,900	12.7
NET INCOME	$111,153	21.4%	$76,682	17.9%	$43,076	16.1%
Average shares outstanding	55,637		46,029		25,338	
NET INCOME PER SHARE	$ 2.00		$ 1.67		$ 1.70	

Consolidated statements of income for Microsoft for each of the four quarters ended March 31, 1988 are presented below. Amounts are in thousands, except net income per share.

	Q87-4	Q88-1	Q88-2	Q88-3	Trailing 12 months
Net revenues	$99,762	$102,636	$155,896	$161,823	$520,117
Cost and expenses:					
Cost of revenues	21,207	21,625	38,573	41,394	122,799
Research and development	11,867	14,603	15,979	17,739	60,188
Sales and marketing	28,034	28,766	38,936	41,747	137,483
General and administrative	6,196	5,332	5,964	5,738	23,230
Total costs and expenses	67,340	70,326	99,452	106,618	343,700
Income from operations	32,458	32,310	56,444	55,205	176,417
Non-operating income	1,976	3,200	1,053	3,478	9,707
Stock option program expense	(8,367)	(3,031)	(3,760)	(4,036)	(19,194)
Income before income taxes	26,067	32,479	53,737	54,647	166,930
Provision for income taxes	8,810	11,220	18,408	17,339	55,777
NET INCOME	$ 17,257	$ 21,259	$ 35,329	$ 37,308	$111,153
Average shares outstanding	55,372	55,536	55,682	55,956	55,637
NET INCOME PER SHARE	$ 0.31	$ 0.38	$ 0.63	$ 0.67	$ 2.00

Net revenues	100.0%	100.0%	100.0%	100.0%	100.0%
Cost and expenses:					
Cost of revenues	21.3	21.1	24.7	25.6	23.6
Research and development	11.9	14.2	10.3	11.0	11.6
Sales and marketing	28.1	28.0	25.0	25.8	26.4
General and administrative	6.2	5.2	3.8	3.5	4.5
Total costs and expenses	67.5	68.5	63.8	65.9	66.1
Income from operations	32.5	31.5	36.2	34.1	33.9
Non-operating income	2.0	3.1	0.7	2.2	1.9
Stock option program expense	(8.4)	(3.0)	(2.4)	(2.5)	(3.7)
Income before income taxes	26.1	31.6	34.5	33.8	32.1
Provision for income taxes	8.8	10.9	11.8	10.7	10.7
NET INCOME	17.3%	20.7%	22.7%	23.1%	21.4%

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Consolidated statements of income for Lotus for each of the four quarters ended March 31, 1988 are presented below. Amounts are in thousands, except net income per share.

	Q87-4	Q88-1	Q88-2	Q88-3	Trailing 12 months
Net revenues	$93,973	$101,199	$115,635	$117,265	$428,072
Cost and expenses:					
Cost of revenues	15,874	16,753	20,155	20,165	72,947
Research and development	14,527	15,234	15,593	20,071	65,425
Sales and marketing	29,855	31,551	38,048	40,389	139,843
General and administrative	12,069	12,218	12,263	12,447	48,997
Total costs and expenses	72,325	75,756	86,059	93,072	327,212
Income from operations	21,648	25,443	29,576	24,193	100,860
Non-operating income	1,611	1,885	3,174	2,015	8,685
Stock option program expense	—	—	—	—	—
Income before income taxes	23,259	27,328	32,750	26,208	109,545
Provision for income taxes	6,978	8,198	9,825	7,862	32,863
NET INCOME	$16,281	$ 19,130	$ 22,925	$ 18,346	$ 76,682
Average shares outstanding	45,733	45,969	46,062	46,353	46,029
NET INCOME PER SHARE	$ 0.36	$ 0.42	$ 0.50	$ 0.40	$ 1.67

Net revenues	100.0%	100.0%	100.0%	100.0%	100.0%
Cost and expenses:					
Cost of revenues	16.9	16.6	17.4	17.2	17.0
Research and development	15.5	15.0	13.5	17.1	15.3
Sales and marketing	31.8	31.2	32.9	34.5	32.7
General and administrative	12.8	12.1	10.6	10.6	11.4
Total costs and expenses	77.0	74.9	74.4	79.4	76.4
Income from operations	23.0	25.1	25.6	20.6	23.6
Non-operating income	1.7	1.9	2.7	1.7	2.0
Stock option program expense	—	—	—	—	—
Income before income taxes	24.7	27.0	28.3	22.3	25.6
Provision for income taxes	7.4	8.1	8.5	6.7	7.7
NET INCOME	17.3%	18.9%	19.8%	15.6%	17.9%

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Consolidated statements of income for Ashton-Tate for each of the four quarters ended January 31, 1988 are presented below. Amounts are in thousands, except net income per share.

	Q87-4	Q88-1	Q88-2	Q88-3	Trailing 12 months
Net revenues	$ 60,211	$63,575	$68,034	$75,508	$267,328
Cost and expenses:					
Cost of expenses	9,527	11,140	12,309	12,755	45,731
Research and development	6,097	6,584	7,301	8,003	27,985
Sales and marketing	14,703	15,146	15,094	18,772	63,715
General and administrative	14,453	13,555	14,509	14,443	56,960
Total costs and expenses	44,780	46,425	49,213	53,973	194,391
Income from operations	15,431	17,150	18,821	21,535	72,937
Non-operating income	814	939	1,066	1,220	4,039
Stock option program expense	—	—	—	—	—
Income before income taxes	16,245	18,089	19,887	22,755	76,976
Provision for income taxes	7,147	7,953	8,800	10,000	33,900
NET INCOME	$ 9,098	$10,136	$11,087	$12,755	$ 43,076
Average shares outstanding	25,154	25,177	25,357	25,663	25,338
NET INCOME PER SHARE	$ 0.36	$ 0.40	$ 0.44	$ 0.50	$ 1.70

Net revenues	100.0%	100.0%	100.0%	100.0%	100.0%
Cost and expenses:					
Cost of revenues	15.8	17.5	18.1	16.9	17.1
Research and development	10.2	10.4	10.7	10.6	10.5
Sales and marketing	24.4	23.8	22.2	24.9	23.8
General and administrative	24.0	21.3	21.3	19.1	21.3
Total costs and expenses	74.4	73.0	72.3	71.5	72.7
Income from operations	25.6	27.0	27.7	28.5	27.3
Non-operating income	1.4	1.5	1.5	1.6	1.5
Stock option program expense	—	—	—	—	—
Income before income taxes	27.0	28.5	29.2	30.1	28.8
Provision for income taxes	11.9	12.6	12.9	13.2	12.7
NET INCOME	15.1%	15.9%	16.3%	16.9%	16.1%

Consolidated statements of financial position for Microsoft, Lotus, and Ashton-Tate are presented below. Amounts are in thousands.

	Microsoft March 31		Lotus April 2		Ashton-Tate January 31	
ASSETS						
Current assets:						
Cash and short-term investments	$181,521	41%	$164,931	48%	$117,640	48%
Accounts receivables - net	86,195	19	63,598	18	58,417	24
Inventory	42,955	10	12,278	4	8,171	3
Other	11,830	3	8,071	2	2,480	1
Total current assets	322,501	73	248,878	72	186,708	76
Property, plant and equipment - net	100,226	23	59,124	17	18,053	7
Intellectual property rights - net	9,193	2	27,975	8	39,899	16
Other assets	8,806	2	8,092	3	2,606	1
TOTAL	$440,726	100%	$344,069	100%	$247,266	100%
LIABILITIES AND STOCKHOLDERS' EQUITY						
Current liabilities:						
Accounts payable	$ 31,029	7%	$ 33,192	10%	$ 22,746	9%
Customer deposits and deferred revenue	8,240	2	12,500	4	–	–
Accrued compensation and employee benefits	13,463	3	10,329	3	8,606	3
Notes payable	11,034	2	9,269	3	2,418	1
Income taxes payable	17,062	4	8,930	2	14,810	6
Other	12,497	3	302	–	11,986	5
Total current liabilities	93,325	21	74,522	22	60,566	24
Long-term liabilities	4,210	1	31,456	9	7,615	3
Stockholders' equity	343,191	78	238,091	69	179,085	72
TOTAL	$440,726	100%	$344,069	100%	$247,266	100%

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Selected market statistics as of April 21, 1988 for Microsoft, Lotus, and Ashton-Tate are presented below.

	Microsoft	Lotus	Ashton-Tate
Closing Stock Price	$54.375	$22.75	$26.875
365-Day High	$79.25	$39.75	$33.00
365-Day Low	$13.75	$19.00	$13.25
Common Shares Outstanding (estimate in millions)	53.4	43.7	24.7
Market Value (in millions)	$2,904	$994	$664
Trailing Twelve Months Revenues (in millions)	$520	$428	$267
Price/Revenues Ratio	5.6x	2.3x	2.5x
Latest Twelve Months EPS	$2.00	$1.67	$1.70
Price/Earnings Ratio	27.2x	13.6x	15.8x
Cash per share	$3.40	$3.78	$4.76
Book value per share	$6.43	$5.45	$7.25

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RESULTS OF OPERATIONS
Compared with Plan

RESULTS OF OPERATIONS COMPARED WITH PLAN

Consolidated

Consolidated statements of income compared with plan are presented below. The first set is for the three months ended March 31, 1988. The second set is for the nine months ended March 31, 1988. Amounts are in thousands, except net income per share.

	Actual		Plan		Variance Percentage
Net revenues	$161,823	100.0%	$112,533	100.0%	43.8
Cost and expenses:					
Cost of revenues	41,394	25.6	24,018	21.3	72.3
Research and development	17,739	11.0	13,553	12.0	30.9
Sales and marketing	41,747	25.8	33,377	29.8	25.1
General and administrative	5,738	3.5	5,307	4.7	8.1
Total costs and expenses	106,618	65.9	76,255	67.8	39.8
Income from operations	55,205	34.1	36,278	32.2	52.2
Non-operating income	3,478	2.1	3,350	3.0	3.8
Stock option bonus expense	(4,036)	(2.5)	(4,500)	(4.0)	(10.3)
Income before income taxes	54,647	33.8	35,128	31.2	55.6
Provision for income taxes	17,339	10.7	10,576	9.4	63.9
NET INCOME	$ 37,308	23.1%	$ 24,552	21.8%	52.0
Average shares outstanding	55,956		56,200		
NET INCOME PER SHARE	$ .67		$ .44		52.3

	Actual		Plan		Variance Percentage
Net revenues	$420,355	100.0%	$316,769	100.0%	32.7
Cost and expenses:					
Cost of revenues	101,592	24.2	69,183	21.8	46.8
Research and development	48,321	11.5	41,727	13.2	15.8
Sales and marketing	109,449	26.0	99,531	31.5	10.0
General and administrative	17,034	4.1	15,599	4.9	9.2
Total costs and expenses	276,396	65.8	226,040	71.4	22.3
Income from operations	143,959	34.2	90,729	28.6	58.7
Non-operating income	7,731	1.8	8,073	2.5	(4.2)
Stock option bonus expense	(10,827)	(2.5)	(5,500)	(1.6)	96.9
Income before income taxes	140,863	33.5	93,302	29.5	51.0
Provision for income taxes	46,967	11.2	28,379	9.0	65.5
NET INCOME	$ 93,896	22.3%	$ 64,923	20.5%	44.6
Average shares outstanding	55,725		55,800		
NET INCOME PER SHARE	$ 1.68		$ 1.16		44.8

Net revenues for the third quarter of fiscal year 1988 at $161.8 million were 43.8% above plan of $112.5 million. As can be seen from the following breakdown of net revenues by Channel of Distribution and Commodity, all channels and all commodities (except CD ROM) experienced favorable revenue variances.

Channel of Distribution	Actual		Plan		Variance Percentage
USSMD	$ 53,258	32.9%	$37,013	32.9%	43.9
International Retail	55,420	34.3	35,998	32.0	54.0
Worldwide Retail	108,678	67.2	73,011	64.9	48.9
Domestic OEM	25,971	16.1	21,809	19.4	19.1
International OEM	22,196	13.7	13,401	11.9	65.6
Worldwide OEM	48,167	29.8	35,210	31.3	36.8
Press	3,067	1.9	2,364	2.1	29.7
Product Support	1,180	0.7	1,015	0.9	16.3
MS Systems Journal	668	0.4	558	0.5	19.7
CD ROM	63	–	375	0.3	(83.2)
CD Consumer	–	–	–	–	–
Total	$161,823	100.0%	$112,533	100.0%	43.8

Commodity	Actual		Plan		Variance Percentage
Applications	$ 63,428	39.2%	$ 48,972	43.5%	29.5
Systems	55,793	34.5	32,676	29.0	70.7
Languages	15,392	9.5	11,335	10.1	35.8
Hardware	19,226	11.9	11,727	10.4	63.9
Books	3,456	2.1	2,541	2.3	36.0
Xenix	2,873	1.8	2,575	2.3	11.6
CD ROM	269	0.2	1,815	1.6	(85.2)
Network	718	0.4	334	0.3	115.0
MS Systems Journal	668	0.4	558	0.5	19.7
CD Consumer	–	–	–	–	–
Total	$161,823	100.0%	$112,533	100.0%	43.8

In terms of revenue generation, the Company's leading products for the quarter (compared with plan) were as follows:

			Actual		Plan	
Actual	Plan		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	DOS/GW Basic	2,060,211	$ 35,824	1,397,686	$20,680
2	3	Microsoft Mouse	248,670	18,691	132,356	10,209
3	2	PC Word	82,641	16,018	48,618	10,985
4	4	Windows	546,633	11,121	255,228	6,623
5	5	Mac Word	41,669	7,762	32,848	6,287
6	7	Mac Excel	31,629	6,834	36,491	5,707
7	6	PC Excel	26,151	6,641	21,093	5,869
8	8	PC Multiplan	54,121	5,520	33,139	4,170
9	10	C Compiler (DOS)	30,525	5,518	13,438	3,172
10	–	PC Word Update	54,723	3,212	10,647	546
11	12	Mac Works	20,873	2,956	15,044	2,289
12	11	Xenix	30,533	2,752	27,448	2,486
13	13	PC Chart	17,200	2,704	13,205	2,133
14	14	Fortran	6,739	2,171	6,581	1,512
15	–	PC Project	7,788	1,744	5,266	1,347
				$129,468		$84,015
		Percent of net revenues		80.0%		74.7%

Net revenues for the first nine months of fiscal year 1988 at $420.4 million were 32.7% above plan of $316.8 million. As can be seen from the following breakdown of net revenues by Channel of Distribution and Commodity, all of the primary channels and commodities experienced favorable revenue variances, whereas most of the secondary channels and commodities experienced revenue shortfalls.

Channel of Distribution	Actual		Plan		Variance Percentage
USSMD	$137,925	32.8%	$109,927	34.7%	25.5
International Retail	136,269	32.4	100,304	31.7	35.9
Worldwide Retail	274,194	65.2	210,231	66.4	30.4
Domestic OEM	79,352	18.9	59,378	18.7	33.6
International OEM	54,500	13.0	33,489	10.6	62.7
Worldwide OEM	133,852	31.9	92,867	29.3	44.1
Press	6,709	1.6	5,907	1.9	13.6
Product Support	3,855	0.9	5,256	1.7	(26.7)
MS Systems Journal	1,368	0.3	1,631	0.5	(16.1)
CD ROM	377	0.1	876	0.2	(57.0)
CD Consumer	-	-	-	-	-
Total	$420,355	100.0%	$316,768	100.0%	32.7

Commodity	Actual		Plan		Variance Percentage
Applications	$ 165,102	39.3%	$ 134,352	42.4%	22.9
Systems	149,046	35.5	97,947	30.9	52.2
Languages	42,602	10.1	32,126	10.1	32.6
Hardware	44,636	10.6	33,523	10.6	33.2
Books	7,759	1.8	6,485	2.0	19.6
Xenix	6,746	1.6	6,496	2.1	3.8
CD ROM	1,552	0.4	3,305	1.0	(53.0)
Network	1,545	0.4	902	0.3	71.3
MS Systems Journal	1,367	0.3	1,632	0.6	(16.2)
CD Consumer	-	-	-	-	-
Total	$420,355	100.0%	$316,768	100.0%	32.7

In terms of revenue generation, the Company's leading products for the nine months ended March 31, 1988 (compared with plan) were as follows:

Actual	Plan		Actual Units	Actual Revenue (in thousands)	Plan Units	Plan Revenue (in thousands)
1	1	DOS/GW Basic	5,299,012	$ 92,720	3,456,141	$ 53,765
2	3	Microsoft Mouse	531,077	43,434	352,288	29,594
3	2	PC Word	186,656	37,921	151,788	32,957
4	4	Mac Word	148,040	25,430	100,719	18,989
5	6	Windows	1,184,193	24,863	516,024	15,501
6	5	Mac Excel	85,859	17,241	92,691	16,040
7	9	PC Excel	62,702	16,667	39,811	10,478
8	7	PC Multiplan	179,717	14,898	113,655	14,561
9	10	C Compiler (DOS)	60,242	12,782	39,291	9,209
10	8	OS/2 SDKs	3,571	8,005	5,140	12,154
11	12	Mac Works	54,341	7,794	46,301	6,974
12	14	Xenix	73,394	6,512	66,423	6,066
13	-	PC Word Update	114,606	6,509	52,830	2,768
14	13	PC Chart	38,331	6,449	41,716	6,567
15	11	PC Works	56,333	5,340	78,150	7,251
				$326,565		$242,874
		Percent of net revenues		77.7%		76.7%

Actual cost of revenues was 25.6% of net revenues compared with a plan of 21.3%. Product costs (material, labor, and overhead) as a percentage of net revenues were 19.4% compared with a plan of 14.7%. All other items included in cost of revenues (royalties, inventory valuation adjustments, freight and distribution department expenses) as a percentage of net revenues were 6.2% compared with a plan of 6.6%. The variance in product cost percentage results from numerous factors including a greater revenue contribution from Hardware (12.3% of total gross revenues compared to a planned 10.6%), higher than anticipated rebates (2.1% of net revenues compared to a planned 1.5%), continued heavy update activity (down from Q88-2 but still well over plan), variance in material costs in many key products (resulting from the size of the package, dual media, and suspect planning assumptions) and the absorption of some expenses related to the move to Campus North. An increase in product returns (with resultant rework or obsolete inventory costs) also contributed to the increase in cost of revenues.

Operating expenses at $65.2 million were 24.9% over plan of $52.2 million and as a percentage of net revenues were 40.3% compared with plan of 46.4%. Categorized in SEC format, Research and Development exceeded plan by 31% ($17.7 million versus $13.6 million), Sales and Marketing exceeded plan by 25% ($41.7 million versus $33.4 million) and General and Administrative exceeded plan by 8% ($5.7 million versus $5.3 million). Expense line items with significant overruns included marketing and advertising ($1.9 million), payroll and payroll taxes ($1.8 million), product development ($1.7 million), supplies and equipment ($1.3 million) and marketing fund programs ($1.1 million). Factors contributing to the overall expense overrun position include higher than anticipated revenues, unplanned activities (e.g. Forethought acquisition, emphasis on marketing fund programs) and the affect of the weak U.S. dollar on the translation of foreign-currency denominated financial statements.

Non-operating income for the quarter was $3.5 million compared with a plan of $3.4 million. Actual non-operating income consists of investment income of $3.0 million, foreign currency transaction gains of $700,000, and miscellaneous expense of $200,000; whereas plan non-operating income consists entirely of investment income. The foreign currency transaction gains result from intercompany borrowings pursuant to our hedging program. See discussion of foreign exchange hedging program on page 70.

Stock option program expense of $4.0 million is the result of the Company's program regarding incentive stock options under which employees, if they elect to participate, receive a cash payment in exchange for taking certain actions that result in a tax benefit to the Company. Under current accounting rules, the Company reports the gross benefit under the program as a contribution to capital, whereas the expense ($4.0 million), net of directly related taxes ($1.3 million), is charged against income, thereby reducing net income by $2.7 million. Of the stock option program expense total, $3,036,000 was actually paid out while the other $1.0 million was accrued. Accounting rules require that this expense be recognized ratably over the vesting period of the related options as opposed to being recognized when paid.

The effective tax rate for the quarter was 31.7% compared with a plan of 30.1%. Our accounting policy is to provide US tax expense on undistributed earnings of subsidiaries operating in countries with tax rates lower than those in the US and to recognize US tax benefit on undistributed earnings of subsidiaries operating in countries with tax rates higher than those in the US. Accordingly, regardless of where we generate pre-tax income, our effective tax rate should be close to the US federal statutory rate of 34%. State income taxes will drive our effective rate above 34%, whereas tax credits (Foreign Sales Corporation and research and experimentation) and tax exempt non-operating income will drive our effective rate below 34%.

Net income for the quarter was $37.3 million compared with a plan of $24.6 million, and as a percentage of net revenues was 23.1% compared with a plan of 21.8%. Had the stock option program discussed above not been adopted, net income would have been $40.0 million, 24.7% of net revenues compared with an adjusted plan of $27.5 million and 24.4%.

Channel Reporting - Q88-3

The contribution (actual and plan) on a channel of distribution basis to net revenues and income from operations for Q88-3 was as follows (amounts in thousands):

	Actual		Plan		Variance Percentage
Net Revenues					
USSMD	$ 53,258	32.9%	$ 37,013	32.9%	43.9
International Retail	55,420	34.3	35,998	32.0	54.0
Worldwide Retail	108,678	67.2	73,011	64.9	48.9
Domestic OEM	25,971	16.1	21,809	19.4	19.1
International OEM	22,196	13.7	13,401	11.9	65.6
Worldwide OEM	48,167	29.8	35,210	31.3	36.8
Press	3,067	1.9	2,364	2.1	29.7
Product Support	1,180	0.7	1,015	0.9	16.3
MS Systems Journal	668	0.4	558	0.5	19.7
CD ROM	63	-	375	0.3	(83.2)
CD Consumer	-	-	-	-	-
Total	$161,823	100.0%	$112,533	100.0%	43.8

		Percentage				Percentage	
		Total	Revenue		Total	Revenue	Variance
Burdened Operating Income (Loss)							
USSMD	$ 6,244	11.3	11.7	$ 5,894	16.2	15.9	5.9
International Retail	19,192	34.8	34.6	9,756	26.9	27.1	96.7
Worldwide Retail	25,436	46.1	23.4	15,650	43.1	21.4	62.5
Domestic OEM	16,177	29.3	62.3	13,453	37.1	61.7	20.2
International OEM	14,443	26.2	65.1	7,220	19.9	53.9	100.0
Worldwide OEM	30,620	55.5	63.6	20,673	57.0	58.7	48.1
Press	592	1.0	19.3	585	1.7	24.7	1.2
Product Support	(546)	(1.0)	(46.3)	(91)	(0.3)	9.0	-
MS Systems Journal	(57)	(0.1)	(8.5)	(5)	-	(0.9)	-
CD ROM	(475)	(0.9)	-	(132)	(0.4)	(35.2)	-
CD Consumer	(369)	(0.7)	-	(403)	(1.1)	-	8.4
Unallocated	-	-	-	-	-	-	-
Total	$55,201	100.0	34.1	$36,277	100.0	32.2	52.2

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Channel Reporting - YTD

The contribution (actual and plan) on a channel of distribution basis to net revenues and income from operations for the first nine months of fiscal year 1988 was as follows (amounts in thousands):

	Actual		Plan		Variance Percentage
Net Revenues					
USSMD	$ 137,925	32.8%	$ 109,927	34.7%	25.5
International Retail	136,269	32.4	100,304	31.7	35.9
Worldwide Retail	274,194	65.2	210,231	66.4	30.4
Domestic OEM	79,352	18.9	59,378	18.7	33.6
International OEM	54,500	13.0	33,489	10.6	62.7
Worldwide OEM	133,852	31.9	92,867	29.3	44.1
Press	6,709	1.6	5,907	1.9	13.6
Product Support	3,855	0.9	5,256	1.7	(26.7)
MS Systems Journal	1,368	0.3	1,631	0.5	(16.1)
CD ROM	377	0.1	877	0.2	0.1
CD Consumer	-	-	-	-	-
Total	$420,355	100.0%	$316,769	100.0%	32.7

		Percentage Total	Percentage Revenue		Total	Percentage Revenue	Variance
Burdened Operating Income (Loss)							
USSMD	$ 17,554	12.2	12.7	$15,465	17.1	14.1	13.5
International Retail	44,567	31.0	32.7	25,612	28.2	25.5	74.0
Worldwide Retail	62,121	43.2	22.7	41,077	45.3	19.5	51.2
Domestic OEM	51,083	35.5	64.4	34,359	37.9	57.9	48.7
International OEM	33,911	23.6	62.2	15,065	16.6	45.0	125.1
Worldwide OEM	84,994	59.1	63.5	49,424	54.5	53.2	72.0
Press	591	0.4	8.8	857	0.9	14.5	(31.0)
Product Support	(1,107)	(0.8)	(28.7)	1,039	1.1	19.8	-
MS Systems Journal	(540)	(0.4)	(39.5)	108	0.1	6.6	-
CD ROM	(1,440)	(1.0)	-	(571)	(0.6)	(65.2)	-
CD Consumer	(668)	(0.5)	-	(1,205)	(1.3)	-	44.6
Unallocated	-	-	-	-	-	-	-
Total	$143,953	100.0	34.2	$90,729	100.0	28.6	58.7

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USSMD

The condensed burdened operating income statement for USSMD for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$53,258	100.0%	$37,013	100.0%	$16,245
Cost of revenues	19,992	37.5	10,479	28.3	(9,513)
Operating expenses	16,784	31.5	11,886	32.1	(4,898)
Allocations - Research and development	6,275	11.8	4,852	13.2	(1,423)
Allocations - Sales and marketing	2,536	4.8	2,622	7.1	86
Allocations - General and administration	1,427	2.7	1,280	3.4	(147)
Burdened operating income	$ 6,244	11.7%	$ 5,894	15.9%	$ 350

The condensed burdened operating income statement for USSMD for FY-88 March year-to-date follows (in thousands):

	Actual		Plan		Variance
Net revenues	$137,925	100.0%	$109,927	100.0%	$27,998
Cost of revenues	47,558	34.5	31,821	28.9	(15,737)
Operating expenses	45,426	32.9	38,085	34.6	(7,341)
Allocations - Research and development	17,484	12.7	14,421	13.2	(3,063)
Allocations - Sales and marketing	5,648	4.1	6,372	5.8	724
Allocations - General and administration	4,255	3.1	3,763	3.4	(492)
Burdened operating income	$ 17,554	12.7%	$ 15,465	14.1%	$ 2,089

USSMD net revenues by commodity for the quarter were as follows (in thousands):

	Actual		Plan		Variance
Books	$ 358	0.7%	$ 184	0.5%	$ 174
Hardware	11,960	22.5	7,137	19.3	4,823
Languages	8,980	16.9	6,799	18.4	2,181
CD ROM	26	-	150	0.4	(124)
Systems	3,533	6.6	2,291	6.1	1,242
Applications	31,259	58.7	21,673	58.6	9,586
Rebates	(2,858)	(5.4)	(1,221)	(3.3)	(1,637)
	$53,258	100.0%	$37,013	100.0%	$ 16,245

Net revenues for Q88-3 at $53.3 million were 43.9% above a plan of $37.0 million. In comparison to the prior quarter, net revenues decreased 1.5% from $54.1 million. Gross revenues at $56.1 million were relatively unchanged compared to $56.4 million in Q88-2. However, rebates increased from 4.3% to 5.4% of net revenues. Under the new reseller contracts which took effect in Q88-3, rebates are now a function of growth-sensitive quotas which replace the minimum volume commitments. Apparently, the quotas were set too low as the directive was to keep the rebate cost at approximately 4% of net revenues.

In terms of gross revenue generation, the division's ten leading products (compared with plan) for the quarter were as follows:

			Actual		Plan		
Q88-3	Q88-2	Product	Units	Revenue	Units	Revenue	Variance
1	1	Microsoft Mouse	128,000	$ 11,286	63,665	$ 5,573	$ 5,713
2	4	PC Word	48,942	6,813	20,760	3,195	3,618
3	3	Mac Word	31,979	5,356	25,393	4,413	943
4	8	Mac Excel	22,610	4,448	18,451	3,353	1,095
5	2	PC Excel	16,539	3,956	10,500	2,443	1,513
6	6	C Compiler (DOS)	14,434	3,183	8,984	1,941	1,242
7	10	Windows	43,059	3,065	40,105	2,291	774
8	9	Mac Works	15,063	2,156	10,025	1,390	766
9	7	PC Word Updates	37,334	1,821	8,000	420	1,401
10	-	Fortran	6,869	1,440	4,490	970	470
Total of Top 10:				$ 43,524		$ 25,989	$ 17,535
Top 10 as Percent of Net Revenues:				81.7%		70.2%	

Net revenues for the Applications commodity, with $31.3 million, decreased 8.8% when compared to $34.3 million in Q88-2. PC Application sales were $17.7 million, decreasing 21.9% from the prior quarter. Mac Application revenues grew, prompted by the ever increasing popularity of the graphics user interface, increasing by 9.1% to $13.9 million in Q88-3. PC Application revenues for Q88-2 were affected by new product releases (PC Excel and PC Works) and a major version release (PC Word 4.0). Of total USSMD Applications revenue dollars, the following shows the quarterly percentage contributed by operating system:

Quarter	PC	Mac	Other
Q88-3	55.8%	43.8%	0.4%
Q88-2	64.0%	35.9%	0.1%
Q88-1	26.3%	72.5%	1.3%
Q87-4	52.8%	47.0%	0.2%
Q87-3	39.5%	60.0%	0.5%
Q87-2	46.1%	53.3%	0.6%
Q87-1	49.4%	49.4%	1.2%

Mouse sales continue to climb, reaching a record 128,000 units with $11.3 million in revenues. Higher production levels contributed to this increased revenue by reducing the previous quarter's large Mouse backorder. Limited quantities of the Mach 20 were shipped in Q88-3. Hardware Marketing feels that the delayed release of Mach 20 may have damaged its momentum in the marketplace.

Languages released a flurry of software late in Q88-3 for both the MS DOS and OS/2 environments. Since the releases occurred late in the quarter, there was a minimal revenue effect. C Compiler revenues of $3.2 million remained stable when compared to last quarter, though shipments of C Compiler were discontinued early in March pending a new software release (version 5.1).

During Q88-3, sales to Distributors ($29.9 million), Dealers and VAD's ($16.8 million) represented 83.1% of gross revenues. Distributor, Dealer, and VAD sales remained relatively stable, compared to Q88-2, slipping by 4.5% ($2.2 million). Fulfillment sales were $3.3 million for Q88-3, a decrease of $1.9 million from $5.2 million in Q88-2. USSMD gross sales by customer type were as follows (in thousands of dollars):

	Q88-3		Q88-2	
	Sales	%	Sales	%
Distributors	$29,872	53.2	$30,620	54.3
Contracted Dealers	12,013	21.4	12,847	22.8
Value Added Dealers	4,762	8.5	4,595	8.1
Education/Government	3,964	7.1	2,252	4.0
Fulfillment	3,290	5.9	5,181	9.2
National Account/Others	2,708	4.8	1,895	3.4
Allowance/Adjustments	(496)	(0.9)	(1,003)	(1.8)
Gross Revenues	$56,113	100.0	$56,387	100.0

Sales to distributors for the past five quarters follow (in thousands):

	Q88-3	Q88-2	Q88-1	Q87-4	Q87-3
Micro D	$11,690	$ 8,510	$ 5,226	$ 5,386	$ 6,389
Softsel	6,014	7,967	3,061	4,260	3,262
Ingram	8,446	9,070	3,017	4,163	5,022
First Software	80	641	1,801	2,500	519
Microamerica	223	73	-	-	-
Gates Distributing	2,932	3,822	1,653	2,022	2,525
Micro United	487	537	241	489	105
	$29,872	$30,620	$14,999	$18,820	$17,822
Percentage of Gross Revenues	53.2%	54.3%	47.1%	53.1%	52.1%

When compared to Q88-2, Micro D purchases in Q88-3 increased by 37.4%. All other distributor purchases declined, resulting in a 2.2% decrease in total distributor purchases. Microamerica was added as a distributor late in Q88-3 replacing First Software. USSMD felt that Microamerica was in a particularly favorable strategic position and able to focus on Microsoft products.

In Q88-3, USSMD processed $3.3 million of returned product which represents 6.2% of this quarter's net revenues. Those products generating the largest returns credits were as follows:

	Returns	
	Units	Returns (in thousands)
PC Word	7,076	$1,200
QuickBasic	1,421	319
Mac Excel	1,514	289
Windows 386	1,889	148
Mac Word	754	137
Mac Works	871	121
	13,525	$2,214
Percentage of Total Returns		67.2%

An analysis of the division's returns shows PC Word at 5,514 units of version 4.0 and 1,562 units of version 3.x is once again at the top of the list. Other Q88-3 returns, largely relating to stock rotation, were spread over a broad range of products. Distributor returns of $1.5 million were 45.3% of total returns.

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Backlog (open orders), ending Q88-3 at $9.5 million, decreased 41.5% from $16.2 million in Q88-2. Net bookings in Q88-3 of $49.7 million decreased 13.5% compared to $57.4 million in Q88-2. A breakdown of the finished goods backlog by significant product follows:

	Backlog	
	Units	Revenue (in thousands)
PC Excel	5,975	$1,578
C Compiler	6,044	1,319
Mac Word	4,952	980
PC Word	4,684	817
Bus Mouse	8,309	699
Mac Excel	2,549	510
PC Works	4,777	496
Serial Mouse	4,749	427
Windows ISV	1,475	318
	43,514	$7,144
Percentage of Total Backlog		75.2%

Software delays contributed to the C Compiler and Windows ISV backlog, while raw material shortages caused the Mouse backlog. With the start-up of Campus North, backlog will be reduced in April and will be insignifcant at year-end.

COST OF REVENUES/GROSS MARGIN

Cost of revenues of $20 million were $9.5 million over a planned $10.5 million. As a percentage of net revenues, cost of revenues were 37.5% against a plan of 28.3%. The resulting gross profit margin for Q88-3 was 62.5% of net revenues compared to a planned 71.7%.

USSMD's gross profit margin for the last four quarters follows:

Q88-3	62.5%
Q88-2	64.4%
Q88-1	72.7%
Q87-4	70.7%

Discounts and Rebates

As previously noted, rebates were 5.4% of net revenues and along with the following cost of revenue factors contributed to the unfavorable USSMD Q88-3 gross profit margin variance. Special pricing and promotional offers to customers such as PC Word pricing, the Academic Excellence program, Ford and Businessland employee offers and deep discounting for dealer sales reps contributed to overall lower gross revenues per unit. The continuation of VAD contracts which contain substantial discounts, and relative increases in Education and governmental sales were other factors in increased Q88-3 discounts.

Product costs

Product costs (material, labor and overhead) as a percentage of net revenues were 25.4% compared with a plan of 20.6%. Factors contributing to higher than planned product costs were increasing documentation and paper costs, dual media and use of more costly outside contract duplication and assembly services. Product unit costs that varied significantly from budget include Mac Works with a plan of $12.55 and an actual cost of $20.55, PC Works with a budgeted unit cost of $18.79 and an actual cost of $26.23, and Mac Word with a plan of $13.71 and an actual of $18.09. Furthermore, on average, Mice costs were approximately $5.00 per unit higher than originally planned.

Product mix

USSMD's product mix also contributed to the negative variance in the cost of revenues to revenues variance. Hardware revenues, with its relatively low margins, represented 22.5% of total revenues compared to a plan of 19.3%. Update and non-finished good sales for Q88-3 were approximately $4.7 million (8% of gross revenues) with a gross profit margin (based on product cost) of 54.5%. These update sales primarily affected the Application, Language and System commodities with high unit update shipments of Word, QuickBasic and Windows.

Returns

The acceleration of previously noted product returns (with resultant rework or obsolete inventory costs) contributed to the decrease in gross margins as a result of the need to increase inventory reserves.

Manufacturing and Distribution Allocations

Allocations of manufacturing and distribution costs were 9.8% of net revenues against a plan of 5.2%. A significant portion of this overrun was due to expenses relating to preparation of the Campus North facility. The rate used to apply manufacturing overhead to inventory was recently increased. This should increase overhead directly applied to inventory, and result in higher product costs and lower allocations of unabsorbed manufacturing and distribution overhead.

OPERATING EXPENSES

Operating expenses at $16.8 million were $4.9 million over a planned $11.9 million, and as a percentage of net revenues were 31.5% versus a planned 32.1%. Significant overruns occurred in marketing fund programs ($1.3 million), marketing ($1.1 million), advertising ($603,000) and supplies and equipment ($494,000).

In Q88-3, the 1988 Distributor/Dealer terms and conditions were implemented. The changes consisted of a decrease in the discount percentage from list price, increased marketing funds for selected (emphasized) products, and a change in the rebate program to growth sensitive from volume sensitive. Moving from quarter-based programs to trimester-based programs, the Winter Campaign began early in Q88-3, focusing on the following 5 emphasized products: PC Word, Mac Word, PC Excel, PowerPoint, and Quick C. Marketing plans, and non-cancellable purchase orders with future ship dates, were submitted to Microsoft. Marketing funds at 4% for non-emphasized and 10% for emphasized products totalling $2.3 million were made available to participating distributors and dealers for implementation of their marketing plans. Sales of the emphasized product were 22.7% of USSMD gross revenues.

Marketing fund programs expense in Q88-3 of $3.3 million (6.2% of net revenues) were 65.2% over a plan of $2 million. This $3.3 million consists of marketing fund activities of $2.8 million and $475,000 in commissions paid to our dealers for sales to large corporate accounts under the Large Volume Account Program (LVA). We currently have 113 dealers who participate in the LVA program. These dealers sell to approximately 405 approved corporate accounts.

Product marketing expense benefiting USSMD during Q88-3 was $2.7 million versus a planned $1.5 million. Marketing material expenditures were $2 million against a planned $1.3 million. Products with significant marketing material expenditures were PC Excel ($685,000) $300,000 of which was for the Excel promotional videos, PC Word ($204,000), PowerPoint ($140,000) and Windows ($130,000). Newsletter's costs, classified as marketing expenditures totalled $227,000.

Advertising expense of $3.2 million was primarily for media expenses ($2.95 million). Below is a product-specific summary of the larger media charges:.

PC Excel	$420,000
MS Works	$354,000
PowerPoint	$238,000
PC Word	$206,000

Corporate media charges (such as recent *Wall Street Journal* advertising) totalled $255,000. Fees paid to Ogilvy & Mather, our new advertising agency, during Q88-3 were $280,000. Our new agreement with Ogilvy & Mather specifies payment based on a "cost plus" arrangement and an additional quarterly "profit incentive" based on Microsoft's actual to budget revenue variances and Ogilvy & Mather's operating profitability.

Supplies and equipment expense totalled $656,000 versus a planned $162,000. Furniture and computer supplies purchased during the move of certain regional offices produced most of this variance.

ALLOCATIONS

Allocations to USSMD were $10.2 million against a planned $8.7 million. Applications development allocations to USSMD exceeded a planned $2.7 million by $1.4 million. As in the prior quarter, much of the Applications variance was caused by costs of the Graphics Business Unit (including amortization of intellectual property acquired). Corpcom support allocations were $331,000 over a planned $848,000 and can be traced in large part to high free-lancer expenditures. Product Support Service (PSS) allocations to USSMD of $2 million overran plan by $251,000. Allocations *from* USSMD *to* Domestic OEM for pre-determined marketing benefit resulted in a favorable variance of $596,000.

BURDENED OPERATING INCOME

USSMD's Q88-3 burdened operating income of $6.2 million was $350,000 over plan. As a percentage of sales, Q88-3 burdened operating income was 11.7% against a planned 15.9% (YTD stands at 12.7% versus a plan of 14.1%). Despite a favorable revenue variance of $16.2 million, USSMD's burdened operating income exceeded plan by only $350,000. Loss of gross margin, heavy marketing (both channel and product) and advertising spending, and a higher than planned allocation from Applications negated the positive revenue variance.

International Retail

The condensed burdened operating income statement for International Retail for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$55,420	100.0%	$35,998	100.0%	$19,422
Cost of revenues	17,266	31.2	10,288	28.6	(6,978)
Operating expenses	10,710	19.3	9,318	25.9	(1,392)
Allocations - Research and development	7,966	14.4	6,310	17.5	(1,656)
Allocations - General and administrative	286	0.5	326	0.9	40
Burdened operating income	$ 19,192	34.6%	$ 9,756	27.1%	$9,436

The condensed burdened operating income statement for International Retail for the first nine months of FY88 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$136,269	100.0%	$100,304	100.0%	$35,965
Cost of revenues	41,032	30.1	27,309	27.2	(13,723)
Operating expenses	28,048	20.6	27,268	27.2	(780)
Allocations - Research and development	21,772	16.0	19,156	19.1	(2,616)
Allocations - General and administrative	850	0.6	959	1.0	109
Burdened operating income	$ 44,567	32.7%	$ 25,612	25.5%	$18,955

International Retail activities are primarily those of wholly owned subsidiaries. Translation of foreign currency denominated financial statements into U.S. dollars affects comparisons to plan by increasing actual amounts if the U.S. dollar is weaker or decreasing actual amounts if the U.S. dollar is stronger than planned. During Q88-3 the U.S. dollar continued to weaken against world currencies. It was moderately weaker than planned in relation to the Australian Dollar, the Canadian Dollar, the Italian Lira and the Swedish Krona (exchange rate variances ranged from 3.7% to 5.4%). It was significantly weaker than planned against all other currencies listed below (exchange rate variances ranged from 7.9% to 13.6%). Actual (weekly average) and planned exchange rates for Q88-3 are as follows:

	U.S. dollars per unit of Foreign Currency	
Currency	Actual Rates	Planned Rate
Australian Dollar	.71749	.69180
British Pound	1.79774	1.58250
Canadian Dollar	.78831	.74760
Deutsch Mark	.59813	.55450
Dutch Guilder	.53248	.49070
French Franc	.17686	.16330
Irish Pound	1.59272	1.44980
Italian Lira	.00081	.00077
Japanese Yen	.00783	.00713
Swedish Krona	.16730	.15870

International Retail Q88-3 net revenues of $55.4 million were 54.0% over a planned $36.0 million and comprised 34.3% of the Company's total Q88-3 net revenues. This $19.4 million favorable variance included a favorable exchange rate variance of $3.9 million. Localized product sales of $32.1 million comprised 57.9% of International Retail Q88-3 net revenues (up from 54.0% for Q88-2).

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A summary of Q88-3 revenues by commodity sold by the International Retail channel follows (in thousands):

	Actual		Plan		Variance
Books	$ 46	0.1%	$ –	–%	$ 46
Hardware	7,630	13.8	4,770	13.3	2,860
Languages	5,949	10.7	3,494	9.7	2,455
CD ROM	(45)	(0.1)	–	–	(45)
Systems	10,111	18.2	2,888	8.0	7,223
Applications	32,103	58.0	25,264	70.2	6,839
Xenix	77	0.1	–	–	77
Rebates	(451)	(0.8)	(418)	(1.2)	(33)
	$55,420	100.0%	$35,998	100.0%	$19,422

Actual and planned Q88-3 retail net revenues of each consolidating unit are as follows (in thousands):

	Actual		Plan		Variance
EUROPE					
MS LTD (England)	$ 5,902	10.7%	$ 3,801	10.6%	$2,101
MS AB (Sweden)	3,910	7.1	2,492	6.9	1,418
MS GmbH (Germany)	13,830	25.0	9,526	26.4	4,304
MS SARL (France)	12,117	21.9	8,465	23.5	3,652
MS BV (Netherlands)	2,176	3.8	1,438	4.0	738
MS SPA (Italy)	2,175	3.9	1,264	3.5	911
MS SRL (Spain)	340	0.6	382	1.1	(42)
Other Europe	548	1.0	-	–	548
	40,998	74.0	27,368	76.0	13,630
ICON					
MS INC (Canada)	4,991	9.0	3,106	8.6	1,885
MS PTY (Australia)	3,481	6.3	1,784	5.0	1,697
Mexico	258	0.5	460	1.3	(202)
Latin America	345	0.6	1,089	3.0	(744)
India	137	0.2	134	0.4	3
Other ICON	392	0.7	54	0.2	338
	9,604	17.3	6,627	18.5	2,977
FAR EAST					
MS KK	3,853	7.0	2,193	6.1	1,660
Korea (MS SA)	5	-	68	0.2	(63)
ASEA	996	1.8	160	0.4	836
Other Far East	415	0.7	–	–	415
	5,269	9.5	2,421	6.7	2,848
Rebates	(451)	(0.8)	(418)	(1.2)	(33)
Total	$55,420	100.0%	$35,998	100.0%	$19,422

The International Retail channel's leading product families for the quarter were as follows:

			Actual		Plan	
Actual	Plan		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	PC Word	53,794	$10,514	26,284	$ 7,238
2	2	Mouse	67,296	7,319	41,691	4,624
3	3	PC Multiplan	35,482	5,052	24,649	4,361
4	–	Packaged DOS	62,367	4,529	15,379	952
5	8	Windows	41,480	3,342	19,760	1,402
6	6	Mac Word	11,753	2,616	7,455	1,873
7	10	C Compiler	9,562	2,540	3,764	1,135
8	4	PC Excel	8,610	2,517	10,593	3,426
9	5	Mac Excel	10,567	2,419	6,940	1,944
10	9	PC Chart	11,222	2,191	6,103	1,201
				$43,039		$28,156
Percent of net revenues				77.7%		78.2%

The table below shows the percentages of International Retail Applications revenues derived from PC, Mac and other system based products in Q88-3 and in each of the previous four quarters.

	PC Based	Mac Based	Other
Q88-3	76.8%	19.9%	3.3%
Q88-2	79.1	18.4	2.5
Q88-1	72.6	24.3	3.0
Q87-4	78.1	18.8	3.1
Q87-3	73.2	20.6	6.2

International Retail cost of revenues was 31.2% of net revenues for Q88-3 compared with a plan of 28.6%. The channel realized lower than planned gross margins in all four principal commodities - hardware, languages, systems and applications (as continued from Q88-2). The gross margin variance results primarily from higher material costs in many key products (caused by the size of the package and dual media), continued higher than anticipated update activity and price reductions resulting from competitive pressure (hardware and languages) or strategic decisions (PC Word and educational customers). The actual and planned gross margin percentages for Q88-3 of the four principal commodities were:

	Gross Margin	
	Actual	Plan
Hardware	53.8%	62.3%
Languages	76.0	83.9
Systems	77.0	83.0
Applications	79.2	81.9

Actual International Retail operating expenses in Q88-3 were $10.7 million or 14.9% greater than plan of $9.3 million. This $1.4 million unfavorable variance includes a $980,000 unfavorable exchange rate variance. The remainder of the Q88-3 over spending results from quarter-to-quarter timing (primarily marketing expenditure slippage). On a year-to-date basis, total operating expenses of $28.0 million are only over plan by $780,000 (less than the year-to-date unfavorable exchange rate variance).

In Q88-3, actual expenses allocated to International Retail were 24.4% over plan, $8.3 million compared with $6.6 million. Allocation variances from Applications development ($1.4 million) and Localization ($264,000) accounted for this extra burden.

Burdened operating income of International Retail in Q88-3 of $19.2 million (34.6% of net revenues) was 96.7% over planned burdened operating income of $9.8 million (27.1% of net revenues). This expansion of the income margin results from a significant increase in net revenues (54.0%) without corresponding relative increases in direct and allocated operating expenses (18.9%). International Retail added a $9.4 million favorable variance to Microsoft's Q88-3 burdened operating income.

Domestic OEM

The condensed burdened operating income statement for Domestic OEM for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$25,971	100.0%	$21,809	100.0%	$4,162
Cost of revenues	2,488	9.6	1,820	8.3	(668)
Operating expenses	1,911	7.4	2,512	11.5	601
Allocations - Research and development	3,979	15.2	3,473	16.0	(506)
Allocations - Sales and marketing	725	2.8	(6)	(0.1)	(731)
Allocations - General and administrative	691	2.7	557	2.6	(134)
Burdened operating income	$16,177	62.3%	$13,453	61.7%	$2,724

The condensed YTD burdened operating income statement for Domestic OEM through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$79,352	100.0%	$59,378	100.0%	$19,974
Cost of revenues	7,647	9.6	5,446	9.2	(2,201)
Operating expenses	4,611	5.8	5,962	10.0	1,351
Allocations - Research and development	10,960	13.8	10,559	17.8	(401)
Allocations - Sales and marketing	3,082	3.9	1,371	2.3	(1,711)
Allocations - General and administrative	1,969	2.3	1,683	2.8	(286)
Burdened operating income	$51,083	64.6%	$34,357	57.9%	$16,726

Domestic OEM net revenues by commodity for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
Books	$ 1	-%	$ –	-%	$ 1
Hardware	166	0.6	72	0.3	94
Languages	813	3.1	1,114	5.1	(301)
Networks	527	2.0	142	0.7	385
CD ROM	236	0.9	261	1.2	(25)
Systems	21,150	81.5	15,937	73.1	5,212
Applications	869	3.3	2,533	11.6	(1,664)
Xenix	2,218	8.6	1,750	8.0	469
Discounts and Rebates	(9)	–	–	–	(9)
Total	$25,971	100.0%	$21,809	100.0%	$4,162
Licensing	$21,116	81.3%	$17,159	78.7%	$3,957
Packaged Product	4,855	18.7	4,650	21.3	205
Total	$25,971	100.0%	$21,809	100.0%	$4,162

Significant Domestic OEM customers, by commodity, for Q88-3 were (in thousands):

	Languages	Systems	Applications	Xenix	Other*	Total Actual		Total Plan	
Zenith	$ 75	$ 2,550	$ 38	$ 6	$(107)	$ 2,562	9.9%	$ 2,514	11.5%
Compaq	-	2,362	-	-	-	2,362	9.1	1,822	8.4
Tandy	387	1,482	118	37	232	2,256	8.7	4,240	19.4
AT&T	2	1,659	71	-	(34)	1,698	6.5	804	3.7
SCO	39	-	38	1,247	54	1,378	5.3	770	3.5
Compuadd	-	397	-	-	875	1,272	4.9	**	-
IBM	76	524	(1)	360	252	1,211	4.7	654	3.0
Paterson	-	420	-	-	720	1,140	4.4	**	-
Wyse	-	787	-	-	345	1,132	4.4	431	2.0
Tandon	1	999	1	-	-	1,001	3.9	842	3.9
AST	-	911	1	-	-	912	3.5	234	1.1
NCR	5	801	1	-	8	815	3.1	296	1.4
Hewlett Packard	9	584	13	-	87	693	2.7	260	1.2
Wang	(20)	551	30	31	26	618	2.4	447	2.0
Commodore	149	414	-	-	-	563	2.2	536	2.5
Kaypro	-	358	190	-	-	548	2.1	356	1.6
DEC	-	505	82	-	(105)	482	1.9	552	2.5
Convergent	2	44	64	-	261	371	1.4	623	2.9
Altos	7	9	22	257	(28)	267	1.0	525	2.4
Amax Eng.	-	260	-	-	-	260	1.0	**	-
GAAP Adjustment	-	(900)	-	-	-	(900)	(3.5)	-	-
UPB Allocations	13	1,523	47	32	(1,615)	-	-	-	-
Other Customers	68	4,910	154	248	(50)	5,330	20.4	5,903	27.0
Total	$813	$21,150	$ 869	$2,218	$ 921	$25,971	100.0%	$21,809	100.0%

* Includes UPB and commodities not listed.
** Customer not individually forecasted

With most of the key customers continuing to out perform expectations, Domestic OEM produced revenues 19.1% over plan for the third quarter. Both licensing and packaged product revenues exceeded plan (23.1% and 4.4%, respectively). On a year-to-date basis, revenues of $79.4 million stand at 133.6% of plan.

Zenith had its biggest quarter ever, shipping in excess of 147,000 units, and maintained its position as the channel's top customer (for the fourth quarter in a row) with revenues of $2.6 million. Almost all of this was systems revenue (MS-DOS and Windows). Compaq's volume of 286/386-based machines remained high, as a result of increased penetration in foreign markets, generating MS-DOS and Windows 386 royalties in excess of plan by $900,000 and $150,000, respectively. This was partially offset by their discontinuance of bundling packaged Windows 386 which was planned to contribute $495,000 in revenue. Tandy's performance was significantly below plan ($2 million). This shortfall resulted from lower than anticipated volume across all commodities. Specific factors worth noting were the delay in shipping of PC Excel, Tandy's discontinuing its Color Computer I, lower sales of its Color Computer II model and significantly lower than forecasted sales of packaged product in Tandy stores. AT&T's unplanned purchase of $673,000 of packaged Windows 386 and Windows was the main contributor to its favorable variance ($894,000). SCO continued to have significant growth in its Xenix-based business, generating a record $1.4 million in revenues. Compuadd and Paterson (now Phoenix Computer Products) were packaged MS-DOS customers which have recently converted to binary license agreements. Neither were individually forecasted, but contributed combined revenues of $1.3 million and $1.1 million, respectively. IBM submitted $354,000 in previously unreported Xenix royalties and $252,000 in "prepaid" language royalties, thus creating its favorable variance. Wyse shipped more 286/386-based machines than planned, resulting in higher MS-DOS royalties. They also paid $345,000 in due on signing for a new OS/2 agreement. Recognition of this amount will, however, be deferred as part of the GAAP adjustment until the product is delivered and accepted. UPB of $1.6 million was the result of due on signing and minimum commitment billings exceeding the amounts reclassified to product specific revenue as royalty reports were received.

This quarter's GAAP adjustment (a negative $900,000) reflects an overall lower accrual for earned but unreported royalties in Q88-3 than was accrued at the end of Q88-2 (accounting for -$600,000), combined with a net increase in deferred revenue related to billings prior to product acceptance (accounting for the remaining -$300,000).

Cost of revenues ($2.5 million against a plan of $1.8 million) was negatively impacted by higher royalty and second sourcing (support) expense related to the increased Xenix revenues (accounting for $270,000 of the variance) and a greater than anticipated allocation of manufacturing and distribution costs (accounting for $394,000 of the variance). The latter was the result of such costs exceeding planned levels.

Operating expenses were favorably impacted by lower than planned marketing expenses ($596,000 - marketing, advertising and public relations). The amount of marketing expenses that are charged to Domestic OEM is determined at the beginning of the fiscal year. Accordingly, this $596,000 favorable direct operating expense variance was offset by an equally unfavorable variance from a marketing allocation from USSMD. Network and Applications development pools exceeded plan and contributed $335,000 and $138,000, respectively, to the $506,000 unfavorable research and development allocation. The $134,000 unfavorable general and administrative allocation resulted primarily from the Corpcom overhead pool exceeding plan.

In summary, the favorable variances in net revenues and operating expenses offset the unfavorable impact in cost of revenues and allocations, resulting in a burdened operating income of $16.2 million, 20.2% above plan. On a year-to-date basis, burdened operating income stands at $51.1 million, 48.7% above plan.

International OEM

The condensed burdened operating income statement for International OEM for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$22,197	100.0%	$13,401	100.0%	$8,796
Cost of revenues	(40)	(0.2)	280	2.1	320
Operating expenses	4,194	18.9	2,765	20.6	(1,429)
Allocations - Research and development	3,257	14.6	2,753	20.5	(504)
Allocations - Sales and marketing	-	-	72	0.5	72
Allocations - General and administrative	343	1.5	311	2.4	(32)
Burdened operating income	$14,443	65.2%	$ 7,220	53.9%	$7,223

The condensed YTD burdened operating income statement for International OEM through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$54,500	100.0%	$33,489	100.0%	$21,011
Cost of revenues	537	1.0	649	1.9	112
Operating expenses	10,503	19.3	8,028	24.0	(2,475)
Allocations - Research and development	8,523	15.8	8,614	25.8	91
Allocations - Sales and marketing	-	-	216	0.6	216
Allocations - General and administrative	1,026	1.8	917	2.7	(109)
Burdened operating income	$33,911	62.1%	$15,065	45.0%	$18,846

International OEM net revenues by commodity for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
Languages	$ 250	1.1%	$ 242	1.8%	$ 8
Networks	189	0.9	184	1.4	5
CD ROM	8	-	1,021	7.6	(1,013)
Systems	20,162	90.8	10,908	81.4	9,254
Applications	1,021	4.6	300	2.2	721
Xenix	567	2.6	746	5.6	(179)
Total	$22,197	100.0%	$13,401	100.0%	$8,796

The contribution (actual and plan) to International OEM net revenues by consolidating unit for Q88-3 follows (in thousands):

	Actual		Plan		Variance
EUROPE					
MS LTD (England)	$ 531	2.4%	$ 692	5.2%	$ (161)
MS AB (Sweden)	591	2.7	578	4.3	13
MS GmbH (Germany)	1,667	7.5	164	1.2	1,503
MS SARL (France)	1,621	7.3	1,301	9.7	320
MS SRL (Spain)	(30)	(0.1)	–	–	(30)
MS BV (Netherlands)	533	2.4	388	2.9	145
MS SpA (Italy)	2,289	10.3	1,823	13.6	466
EIKON (Joint Venture)	–	–	1,500	11.2	(1,500)
	7,202	32.5	6,446	48.1	756
ICON					
MS INC (Canada)	1,548	7.0	–	–	1,548
MS PTY (Australia)	84	0.4	–	–	84
Mexico	72	0.3	–	–	72
Latin America	21	0.1	–	–	21
India	6	0.0	–	–	6
Other ICON	99	0.4	–	–	99
	1,830	8.2	–	–	1,830
FAR EAST					
MS KK (Japan)	3,299	14.9	3,854	28.7	(555)
Korea (MS SA)	3,734	16.8	1,965	14.7	1,769
ASEA	5,232	23.6	1,136	8.5	4,096
	12,265	55.3	6,955	51.9	5,310
GAAP Adjustment	900	4.0	–	–	900
Total	$22,197	100.0%	$13,401	100.0%	$8,796

Significant International OEM customers, by commodity, for Q88-3 were (in thousands):

	Languages	Systems	Applications	Xenix	Other*	Total Actual		Total Plan	
Olivetti	$ 7	$ 2,012	$ –	$ 19	$ (5)	$ 2,033	9.2%	$ 1,736	13.0%
Copam	–	296	–	–	1,250	1,546	7.0	138	1.0
Philips Elec.	–	–	–	–	1,334	1,334	6.0	**	–
Siemens	5	441	38	107	492	1,083	4.9	141	1.1
Bull S.A.	(5)	442	277	–	221	935	4.2	629	4.7
Hyundai Elec.	–	776	–	–	74	850	3.8	500	3.7
Multitech Ind.	–	1,328	–	–	(496)	832	3.7	265	2.0
Gold Star	–	743	–	–	(19)	724	3.3	175	1.3
Epson	65	659	–	–	–	724	3.3	95	0.7
Daewoo Telecom	–	675	–	–	(50)	625	2.8	680	5.1
Samsung Semicond.	–	–	–	–	600	600	2.7	**	–
ASCII	–	560	–	–	–	560	2.5	**	–
Philips Telecom	–	520	–	–	8	528	2.4	69	0.5
Video Tech.	–	90	–	–	414	504	2.3	**	–
Matsushita Elec.	–	976	–	–	(525)	451	2.0	30	0.2
Bondwell Holding	–	106	–	–	336	442	2.0	**	–
Lyi-Cheng	–	432	–	–	–	432	1.9	60	0.4
IBM-Japan	55	–	329	–	–	384	1.7	63	0.4
Opus	–	–	–	–	378	378	1.7	**	–
Cordata	–	101	–	–	270	371	1.7	**	–
Ericsson	–	316	–	–	9	325	1.5	325	2.4
GAAP Adjustment	–	900	–	–	–	900	4.1	**	–
UPB Allocations	–	1,113	–	–	(1,113)	–	–	**	–
Other Customers	123	7,676	377	441	(2,981)	5,636	25.3	8,495	63.5
Total	$250	$20,162	$1,021	$567	$ 197	$22,197	100.0%	$13,401	100.0%

* Includes UPB and commodities not listed.
** Customer not individually forecasted.

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Q88-3 marked the third quarter in a row that International OEM benefited from favorable market conditions. The channel generated revenues in excess of plan by $8.8 million (65.6%). This was achieved without the benefit of a planned $1.5 million in revenue from the EIKON joint venture. The agreement concerning EIKON's license of CD ROM products has not yet materialized. Once again, almost all key customers exceeded expectations with the primary benefit going to the Systems commodity. On a year-to-date basis, revenues of $54.5 million are 162.7% of plan.

Olivetti continued to be the channel's top customer with more than $2 million in systems revenue. Siemens generated unplanned revenue of $1.1 million. This was primarily due to a $500,000 Xenix related minimum commitment and $400,000 for their acceptance of OS/2. Bull generated $227,000 in unforecasted minimum commitments and $97,000 in excess applications royalties (Word, Multiplan and Chart). The $560,000 from ASCII represents MSX royalties received upon settlement of the two year old dispute which arose when we dissolved our agency relationship. Greater than forecasted MS-DOS royalties accounted for the majority of the following favorable revenue variances: Epson ($629,000); Multitech ($567,000); Goldstar ($549,000); Philips Telecom ($459,000); Matsushita ($421,000); Lyi-Cheng ($372,000); and Hyundai ($350,000). IBM-Japan submitted past due royalty reports, thus generating Multiplan and Chart revenue that was $321,000 over planned figures. UPB of $1.1 million represents due on signing and minimum commitment billings exceeding the amounts reclassified to product specific revenue as royalty reports were received. This UPB figure is net of a $1.1 million negative adjustment related to an agreement which allowed Apricot to recoup prepaid royalties against purchases of products from MS Ltd. The more significant due on signing amounts were: Philips Electronics ($1.3 million - MS-DOS and MS-DOS Manager); Copam ($625,000 plus an additional minimum commitment of $625,000 - MS-DOS); Samsung Semiconductor ($600,000 - MS-DOS); Opus ($377,500 - MS-DOS); Video Technology ($366,000 - MS-DOS); NEC ($250,000 - GW-Basic Interpreter); and Cheung Lab ($230,000 - MS-DOS). Total due on signing billings exceeded $5.5 million. The Philips Electronics account was transferred from MS BV (Netherlands) to MS INC (Canada). Their above mentioned $1.3 million due on signing is the major factor behind MS INC's $1.5 million total revenue. The $900,000 GAAP adjustment reflects an overall higher accrual for earned but unreported royalties in Q88-3 than was accrued at the end of Q88-2 (accounting for $2.3 million), partially offset by a net increase in deferred revenue related to billings prior to product acceptance (accounting for a -$1.4 million).

The negative cost of revenues resulted from an adjustment to decrease an existing accrual for Xenix related royalty and second source (support) expenses. The adjustment brought the accrual in line with the actual liability existing at the end of the quarter.

The most significant contributor to the $1.4 million unfavorable operating expense variance was the excess of actual revenue over plan. Commissions paid to MS SA, our Korean sales agent, were $355,000 greater than plan, representing 20% of the excess revenues generated by that organization. Bad debt expense, provided at three percent of revenue, exceeded plan by $281,000. B&O taxes which are also tied to revenues, were $170,000 greater than plan. Payroll and related expenses exceed plan by $139,000. Professional fees (resulting from higher legal costs related to our efforts in Brazil) contributed another $104,000 to the overall variance.

International OEM was negatively impacted in the allocations area by the Network development and International R&D (localization) pools exceeding plan ($325,000 and $344,000, respectively). These overruns were partially offset by a favorable variance in the allocation of CD ROM development costs. This resulted from the favorable impact of a change in methodology for allocating such costs. Subsequent to the finalization of the plan for FY'88, revenue generated by the EIKON joint venture was determined to belong to the CD ROM channel instead of International OEM, as originally envisioned. Consequently, the International OEM channel receives less CD ROM commodity revenue and less allocation of CD ROM development costs than planned, while the opposite occurs in the CD ROM channel.

In summary, burdened operating income of $14.4 million (65.2% of net revenues) against a plan of $7.2 million (53.9% of net revenues) produced a favorable variance of $7.2 million. This positive effect results from a significant increase in net revenues (65.6%) without corresponding relative increases in expenses (25.4%). As a result, 82.1% of the additional revenue flowed through to the channel's operating income line. On a year-to-date basis, operating income of $33.9 million is more than double the plan of $15.1 million (225.1%).

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Press

The condensed burdened operating income statement for Press for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$3,067	100.0%	$ 2,364	100.0%	$ 703
Cost of revenues	1,421	46.3	896	37.9	(525)
Operating expenses	440	14.3	359	15.2	(81)
Allocations - Research and development	562	18.3	475	20.1	(87)
Allocations - General and administrative	52	1.6	49	2.0	(3)
Burdened operating income	$ 592	19.3%	$ 585	24.8%	$ 7

The condensed burdened operating income statement for Press for FY-88 March year-to-date follows (in thousands):

	Actual		Plan		Variance
Net revenues	$6,709	100.0%	$ 5,907	100.0%	$ 802
Cost of revenues	3,103	46.3	2,271	38.5	(832)
Operating expenses	1,043	15.6	1,078	18.3	35
Allocations - Research and development	1,818	27.1	1,557	26.4	(261)
Allocations - General and administrative	154	2.2	144	2.3	(10)
Burdened operating income	$ 591	8.8%	$ 857	14.5%	$ (266)

Press revenues by subject category for Q88-3, as compared to plan, were as follows:

	Actual		Plan	
	Revenue (in thousands)	Percent	Revenue (in thousands)	Percent
MS DOS books (29 titles)	$2,299	75.0%	$1,925	81.5%
OS/2 books (1 title)	276	9.0	182	7.7
MAC books (17 titles)	269	8.8	157	6.6
General books (35 titles)	152	4.9	100	4.2
Foreign publishers	76	2.5	0	0.0
Rebates	(5)	(0.2)	0	0.0
	$3,067	100.0%	$2,364	100.0%

The channel's leading revenue generating titles, compared to plan, for the quarter were as follows:

	Actual		Plan	
	Units	Revenue (in thousands)	Units	Revenue (in thousands)
Running MS DOS	83,088	$ 904	75,900	$ 860
MS-DOS Encyclopedia	8,533	405	375	19
Inside OS/2	36,634	276	11,750	121
Advanced MS-DOS	10,880	169	4,000	47
Peter Norton Programmer's Guide	11,783	155	3,900	40
Programming Windows	10,806	136	1,250	15
Supercharging DOS	8,514	111	2,750	27
MAC Word Book	9,271	101	6,300	65
Excel In Business (MAC)	5,995	72	800	9
Word Processing Power (DOS)	6,531	69	1,050	11
		$2,398		$1,214
Percent of net revenues		78.2%		51.4%

Press net revenues of $3.1 million exceeded plan by $703,000, resulting in a positive variance of 29.7%. The increase in revenues is due to the fact that market acceptance of several new titles significantly exceeded plan. Specifically, sales of the 3rd edition of Running MS-DOS, MS-DOS Encyclopedia (released in December 1987), Inside OS/2, and Advanced MS-DOS were $707,000 over plan. Additionally, sales of many existing titles significantly exceeded plan. Sales of the top ten titles were $2.4 million, $1.2 million above plan, accounting for 78.2% of net revenues. These positive revenue variances were offset by the fact that six new titles, forecast to generate revenue of $615,000, were not published during the quarter.

Actual cost of revenues was 46.3% of net revenues compared with a plan of 37.9%. Product costs (material, labor and overhead) as a percentage of net revenues were 18.3% compared with a plan of 16%. This is in part due to paper costs which were higher than expected. In general, the market price of paper has increased significantly over the past year. All other items included in costs of revenues (inventory, valuation adjustments, royalties, distribution costs and other) totalled 28% of net revenues compared with a plan of 21.9%. This variance is due primarily to a consistent unplanned increase in distribution fees and freight costs.

Operating expenses at $440,000 exceeded a plan of $359,000 by 22.6%. As a percentage of net revenue, operating expenses were 14.3% compared to a plan of 15.2%. The most significant unfavorable variances were in marketing and product development. This was largely due to delayed marketing associated with the six titles originally scheduled for publication in Q88-2 and also to the late production of the spring catalog.

Allocations to the Press channel were $614,000 against plan of $524,000. The unfavorable variance was primarily the result of higher than anticipated book development expenses which were $562,000, compared to a plan of $475,000 and were due primarily to development costs for the World of Math series..

In summary, Press' burdened operating income of $592,000 was above the planned operating income of $585,000. The Q88-3 results can be attributed to sales that are higher than anticipated, offset by an unfavorable cost of revenues to net revenues ratio (46.3% versus a planned 37.9%) and unfavorable variances in direct operating expenses and allocated book development expenses. Year-to-date, Press' burdened operating income of $591,000 is up significantly from Q88-2, but is still below planned income of $857,000. With continued strong sales expected on existing titles and the late release of several new titles, Q88-4's results should recover some of this shortfall. Press' burdened operating income in Q88-4 should be well above plan of $225,000.

Product Support Services (PSS)

The condensed burdened operating income statement for PSS for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$1,180	100.0%	$1,015	100.0%	$ 165
Cost of revenues	103	8.7	53	5.2	(50)
Operating expenses	3,172	268.9	2,402	236.7	(770)
Allocations - Sales and marketing	(2,083)	(176.5)	(1,840)	(181.3)	243
Allocations - General and administrative	534	45.3	491	48.4	(43)
Burdened operating loss	$ (546)	(46.4)%	$ (91)	(9.0)%	$(455)

The condensed YTD burdened operating income statement for PSS through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 3,855	100.0%	$5,255	100.0%	$(1,400)
Cost of revenues	1,267	32.9	1,202	22.9	(65)
Operating expenses	7,602	197.2	6,903	131.3	(699)
Allocations - Sales and marketing	(5,497)	(142.6)	(5,331)	(101.4)	166
Allocations - General and administrative	1,590	41.2	1,442	27.5	(148)
Burdened operating income (loss)	$(1,107)	(28.7)%	$1,039	19.7%	$(2,146)

PSS net revenues by commodity for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
Hardware	$ –	–%	$ 2	0.2%	$ (2)
Languages	102	8.7	31	3.1	71
Network	1	0.1	8	0.8	(7)
CD ROM	2	0.2	12	1.2	(10)
Systems	1,041	88.2	767	75.6	274
Applications	20	1.6	115	11.2	(95)
Xenix	14	1.2	80	7.9	(66)
	$1,180	100.0%	$1,015	100.0%	$165

The sources of PSS net revenues for Q88-3 were as follows (in thousands):

	Actual	Plan	Variance
MSU	$ 570	$ 250	$320
DIAL (non-SDK related)	170	765	(595)
OS/2 SDK related	440	–	440
	$1,180	$1,015	$165

The Product Support Services (PSS) channel generates revenue through its on-line technical assistance subscription service (DIAL) and through Microsoft University (MSU), which provides training seminars on a wide range of Microsoft products. These seminars are primarily aimed at ISV's and other software developers. Accordingly, they have centered around Microsoft operating environments and languages. Titles of seminars with the highest demand are: "Programming in Microsoft C"; "Microsoft Windows API Programming"; and "MS OS/2 Device Drivers". PSS also receives revenue credit for a training video included in the SDK as well as SDK related DIAL revenue. The latter is amortized over a one-year period. Such amortization was not foreseen in the plan.

The positive variance in net revenues of $165,000 is primarily due to a high attendance rate for MSU courses, an increase in MSU courses at client sites and unplanned sales of OS/2 SDK's. Non-SDK related DIAL revenues were still under plan but were increasing over the previous quarter. An upcoming product release to supersede DIAL is expected to generate increased revenues.

The $50,000 variance for cost of revenues is principally the result of processing final expenses for last fall's OS/2 conferences. The major components behind the $770,000 unfavorable operating expense variance were: payroll and payroll related expenses ($284,000); supplies and equipment ($117,000); marketing ($105,000); and professional fees ($101,000). The payroll related expense variance resulted from staffing in excess of planned levels. At quarter-end, total PSS headcount was 211 against a planned 195. Within PSS, MSU had 14 people compared with a plan of 9. The remaining variances mentioned above were principally related to MSU and the move to its new location. Certain expenses incurred by the channel are allocated out to USSMD and Domestic OEM based upon perceived benefit. Such expenses exceeded planned levels for the quarter. Consequently, more dollars were allocated out to the above channels, thus generating the positive variance in sales and marketing allocations.

In summary, the positive revenue variance for the quarter was outweighed by the net unfavorable expense variances, producing an operating loss of $546,000 against a planned loss of $91,000. Year-to-date results show a net operating loss of $1.1 million against a planned income of $1.0 million. This year-to-date situation results from a revenue shortfall and an operating expense overrun.

CD ROM Channel

The condensed burdened operating income statement for CD ROM for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 63	100.0%	$ 375	100.0%	$(312)
Cost of revenues	–	–	–	–	–
Operating expenses	220	352.1	291	77.5	71
Allocations - Research and development	271	432.3	172	45.9	(99)
Allocations - General and administrative	47	75.4	44	11.8	(3)
Burdened operating loss	$(475)	(759.8)%	$(132)	(35.2)%	$(343)

The condensed YTD burdened operating income statement for CD ROM through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 376	100.0%	$ 875	100.0%	$(499)
Cost of revenues	–	–	–	–	–
Operating expenses	642	170.7	822	94.0	180
Allocations - Research and development	1,036	275.4	495	56.6	(541)
Allocations - General and administrative	138	36.5	129	14.7	(9)
Burdened operating loss	$(1,440)	(382.6)%	$(571)	(65.3)%	$(869)

The discussion below concentrates on the CD ROM sales channel. A more accurate picture of the CD ROM business may be obtained from reviewing the discussion of CD ROM as a commodity (see page 55).

The CD ROM channel receives credit for revenue generated by Beta Partner Agreements and the EIKON joint venture. Revenues of $63,000 were generated by a Beta Partner Agreement with US West for the development of a customized CD ROM application. This amount resulted from the customer's acceptance of the developed application. Recognition of the Beta Partner revenue is deferred until our obligations under the individual agreements are fulfilled. Such deferral was not foreseen by the plan. This, combined with a change in strategy to postpone the pursuit of new Beta Partnership opportunities, resulted in the overall unfavorable variance. However, at the end of the quarter, a total of $187,500 remains as deferred revenue and will be recognized in future periods.

The favorable $71,000 operating expense variance was primarily due to payroll, recruiting and travel & entertainment expenses below planned levels. The negative $99,000 variance in allocated R&D expenses resulted from the effect of a change in methodology for allocating CD ROM development costs. Such costs are allocated to the various channels based upon their planned relative percentage of total CD ROM commodity revenue. Subsequent to finalization of the plan for FY'88, revenue generated by the EIKON joint venture was determined to belong to the CD ROM channel instead of International OEM, as originally envisioned. As a result, CD ROM channel receives more CD ROM commodity revenue and more allocation of CD ROM development costs than planned, while the opposite occurs in the International OEM channel.

In summary, lower than planned revenues from Beta Partner Agreements, combined with the higher R&D allocations, produced a net burdened operating loss for the quarter of $475,000 compared with a planned loss of $132,000. The same factors are responsible for the year-to-date loss of $1.4 million against the planned loss of $571,000. Again, for a fuller picture of our CD ROM business, see the commodity discussion later in this report.

Commodity Reporting - Q88-3

The contribution (actual and plan) on a commodity basis to net revenues and income from operations for Q88-3 follows (amounts in thousands):

	Actual		Plan		Variance Percentage
Net Revenues					
Applications	$ 63,429	39.2%	$ 48,972	43.5%	29.5
Systems	55,793	34.5	32,676	29.0	70.7
Languages	15,392	9.5	11,335	10.1	35.8
Hardware	19,226	11.9	11,727	10.4	63.9
Books	3,456	2.1	2,541	2.3	36.0
Xenix	2,873	1.8	2,575	2.3	11.6
CD ROM	269	0.2	1,815	1.6	(85.2)
Networks	718	0.4	334	0.3	115.0
MS Systems Journal	667	0.4	558	0.5	(19.7)
CD Consumer	–	–	–	–	-
Total	$161,823	100.0%	$112,533	100.0%	43.8

	Actual	Percentage Total	Percentage Revenue	Plan	Percentage Total	Percentage Revenue	Variance
Burdened Operating Income (Loss)							
Applications	$12,917	23.4	20.4	$13,314	36.7	27.2	(3.0)
Systems	35,426	64.2	63.5	17,733	48.9	54.3	99.8
Languages	3,841	7.0	25.0	2,477	6.8	21.9	55.1
Hardware	3,394	6.1	17.7	1,970	5.4	16.8	72.3
Books	688	1.2	20.0	579	1.6	22.8	18.8
Xenix	1,142	2.1	39.7	743	2.0	28.9	53.7
CD ROM	(713)	(1.3)	(265.1)	468	1.3	25.8	-
Networks	(1,068)	(1.9)	(148.7)	(598)	(1.6)	(179.0)	(78.6)
MS Systems Journal	(57)	(0.1)	(8.5)	(5)	–	(0.9)	-
CD Consumer	(369)	(0.7)	-	(404)	(1.1)	–	8.7
Unallocated	–	–	-	–	–	-	-
Total	$55,201	100.0	34.1	$36,277	100.0	32.2	52.2

Commodity Reporting - YTD

The contribution (actual and plan) on a commodity basis to net revenues and income from operations for the first nine months of fiscal year 1988 follows (amounts in thousands):

	Actual		Plan		Variance Percentage
Net Revenues					
Applications	$ 165,102	39.3%	$ 134,352	42.4%	22.9
Systems	149,046	35.5	97,947	30.9	52.2
Languages	42,602	10.1	32,126	10.1	32.6
Hardware	44,636	10.6	33,523	10.6	33.2
Books	7,759	1.8	6,485	2.0	19.6
Xenix	6,746	1.6	6,496	2.1	3.8
CD ROM	1,552	0.4	3,305	1.0	(53.0)
Networks	1,545	0.4	902	0.3	71.3
MS Systems Journal	1,367	0.3	1,632	0.6	(16.2)
CD Consumer	-	-	-	-	-
Total	$420,355	100.0%	$316,768	100.0%	32.7

		Percentage Total	Percentage Revenue		Percentage Total	Percentage Revenue	Percentage Variance
Burdened Operating Income (Loss)							
Applications	$33,995	23.6	20.6	$28,150	31.0	21.0	20.8
Systems	95,023	66.0	63.8	53,030	58.5	54.1	79.2
Languages	10,834	7.5	25.4	5,938	6.5	18.5	82.5
Hardware	6,523	4.5	14.6	4,485	4.9	13.4	45.4
Books	798	0.6	10.3	856	0.9	13.2	(6.8)
Xenix	1,621	1.1	24.0	1,544	1.7	23.8	5.0
CD ROM	(1,840)	(1.3)	(118.6)	(486)	(0.5)	(14.7)	(278.6)
Networks	(1,793)	(1.2)	(116.1)	(1,693)	(1.9)	(187.7)	(5.9)
MS Systems Journal	(540)	(0.4)	(39.5)	108	0.1	6.6	(600.0)
CD Consumer	(668)	(0.4)	-	(1,205)	(1.2)	-	(44.6)
Unallocated	-	-	-	-	-	-	-
Total	$143,953	100.0	34.2	$90,727	100.0	28.6	58.7

Applications

The condensed burdened operating income statement for Applications for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$63,429	100.0%	$48,972	100.0%	$14,457
Cost of revenues	17,754	28.0	11,791	24.1	(5,963)
Operating expenses	14,906	23.5	9,550	19.5	(5,356)
Allocations - Research and development	3,439	5.4	2,511	5.1	(928)
Allocations - Sales and marketing	12,855	20.3	10,508	21.4	(2,347)
Allocations - General and administrative	1,558	2.4	1,298	2.7	(260)
Burdened operating income	$12,917	20.4%	$13,314	27.2%	$ (397)

The condensed burdened operating income statement for Applications for FY-88 March year-to-date follows (in thousands):

	Actual		Plan		Variance
Net revenues	$165,102	100.0%	$134,352	100.0%	$30,750
Cost of revenues	44,321	26.9	32,925	24.5	(11,396)
Operating expenses	40,774	24.7	31,396	23.4	(9,378)
Allocations - Research and development	8,160	4.9	7,291	5.4	(869)
Allocations - Sales and marketing	33,401	20.2	30,680	22.8	(2,721)
Allocations - General and administrative	4,451	2.7	3,910	2.9	(541)
Burdened operating income	$ 33,995	20.6%	$ 28,150	21.0%	$ 5,845

Applications net revenues by channel for the quarter were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$31,259	49.3%	$21,674	44.3%	$ 9,585
International Retail	32,102	50.6	25,264	51.6	6,838
Domestic OEM	870	1.4	2,533	5.2	(1,663)
International OEM	1,021	1.6	300	0.6	721
Product Support Sales	19	-	114	0.2	(95)
Rebates (mainly USSMD)	(1,842)	(2.9)	(913)	(1.9)	(929)
	$63,429	100.0%	$48,972	100.0%	$14,457

Net revenues for Q88-3 at $63.4 million were 29.5% above plan of $49.0 million. The current quarter set a new revenue record for the Application commodity, surpassing the $61.4 million recorded in the preceding quarter. In terms of revenue generation, the commodity's ten leading products (compared with plan) for the quarter were as follows:

			Actual		Plan	
Q88-3	Q88-2		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	PC Word	82,641	$16,018	48,618	$10,985
2	3	Mac Word	41,669	7,762	32,848	6,287
3	5	Mac Excel	31,629	6,834	36,491	5,707
4	2	PC Excel	26,151	6,641	21,093	5,869
5	4	PC Multiplan	54,121	5,520	33,139	4,170
6	8	PC Word Update	54,723	3,212	10,647	546
7	7	Mac Works	20,873	2,956	15,044	2,288
8	9	PC Chart	17,200	2,704	13,205	2,133
9	-	PC Project	7,788	1,744	5,266	1,347
10	6	PC Works	17,185	1,522	41,586	3,970
				$54,913		$43,302
Percentage of net revenues				86.6%		88.4%

The top selling products for both the PC and Mac operating systems are Word and Excel. PC Word is again the No. 1 product with revenues of $16.0 million, surpassing Q88-2 with a 32.6% increase. Mac Excel moved into the No. 3 position with revenues of $6.8 million, an increase of 68.3% over last quarter's $4.1 million. PC Excel dropped from No. 2 to No. 4 in Q88-3 with a 33.8% decrease. Update sales for PC Word continued strong with revenues of $3.2 million (54,723 units) compared to $3.0 million (52,650 units) in Q88-2, a 7.9% increase. There were no new major product introductions in Q88-3; however, products released in previous quarters continued to generate revenues, but PC Works was under its quarter plan.

The following table shows PC Applications versus Mac Applications by channel for Q88-3 (in thousands):

	USSMD		International Retail		Worldwide OEM		Total Q88-3		Total Q88-2
PC Apps	$17,691	27.1%	$24,146	37.0%	$1,769	2.7%	$43,606	66.8%	71.1%
Mac Apps	13,852	21.2	6,283	9.6	34	-	20,169	30.9	27.6
Returns reserve	(284)	(0.4)	1,673	2.6	88	0.2	1,477	2.3	1.3
	$31,259	47.9%	$32,102	49.2%	$1,891	2.9%	$65,252	100.0%	100.0%
Rebates and PSS							(1,823)		
Net revenue							$63,429		

In terms of revenue generation, International Retail at $32.1 million, topped USSMD by $843,000. PC Application sales through USSMD decreased 21.8% from Q88-2 to Q88-3 as a result of a decline in revenues from PC Excel, PC Works, and PC Flight Simulator. International Retail continued to experience growth in PC Application revenues from $12.8 million in Q88-1 and $21.2 million in Q88-2 to $24.1 million in Q88-3. Mac Application sales for both retail channels experienced growth, with USSMD increasing 9.1% ($13.9 million versus $12.7 million) and International Retail increasing 27.9% ($6.3 million versus $4.9 million) over last quarter.

Cost of revenues for Applications during Q88-3 was $17.8 million against a planned $11.8 million. As a percentage of net revenues, cost of revenues were 28.0% compared to a budget of 24.1%. Consistent with Q88-2, the product cost component of overall Applications cost of revenues was forecast at 16.3%, but came in at 20.7%. Heavy update revenues and higher than anticipated Word sales (37.5% of net revenues compared with a planned 35.3%; with a 65% discount) contributed to the lower gross margin percentages. As Q88-3's No. 2 Applications revenue product, Mac Word's standard unit cost was $18.09 compared to a planned $13.71. This quarter's No. 7 Applications revenue product, Mac Works, had a budgeted standard unit cost of $12.55, but came in at $26.23. PC Works, Q88-3's No. 10 revenue generating Applications product, was budgeted at $18.79 although actual unit costs have been $26.23. Other non-product cost items included in cost of revenues (as a percentage of net revenues) were 6.2% compared with a plan of 7.8%. Although royalties of $1.1 million were the same as forecasted, royalties as a percentage of revenues were only 1.8% as opposed to a budget of 2.4%. See the table below for a listing of significant royalty bearing products.

Product	Revenue	Royalty	Percent
Mac Works	$3,021	$ 526	17.4
Project	1,901	274	14.4
Flight Simulator	607	133	21.9
Word	27,277	95	0.3
RBase	747	78	10.4
Other	498	43	8.6
		$1,149	

Application operating expenses of $14.9 million were $5.4 million over plan. As a percentage of net revenues, operating expenses were 23.5% compared to a plan of 19.5%. Most of this variance originated in the areas of marketing fund programs ($1.0 million), advertising and marketing ($2.0 million), and product development ($1.3 million).

Marketing fund program expense totalled $1.1 million compared with a planned $138,000. USSMD's Winter Campaign, which emphasized Applications products, caused the variance. Advertising and marketing expenditures were $6.3 million during Q88-3, overrunning a plan of $4.3 million by $2.1 million. Relatively significant product expenditures for advertising and marketing are shown below (in thousands):

	Advertising	Marketing	Total
MS Excel	$472	$685	$1,157
MS Works	359	104	463
PC Word	249	204	453
PowerPoint	263	140	403
	$1,343	$1,133	$2,476

Samples expenses for Applications products during Q88-3 (a component of marketing) approximated $470,000.

Product development expenditures of $2.3 million overran plan by $1.3 million. Costs of the Graphics Business Unit (including amortization of acquired intellectual property rights) along with localization free-lance costs were responsible for most of the product development variance. Additional negative budget variances occurred in payroll, professional fees, bad debts and building and grounds distribution.

Allocations to Applications were $3.5 million over a plan of $14.3 million. As a percentage of net revenues, allocations were 28.1% compared to a planned 29.2%. The sales and marketing allocation was $2.7 million over plan and was due to overruns in the USSMD pool ($1.6 million). User Education allocations were $866,000 over plan (due to a year-to-date adjustment) and International Retail allocations were $502,000 over plan.

The Q88-3 burdened operating income for Applications was $12.9 million compared to plan of $13.3 million, resulting in a net $400,000 under plan, despite a favorable revenue variance of $14.5 million. Less than anticipated gross profit margin, heavy marketing and advertising spending, unplanned product development related to the Forethought acquisition, and a higher than planned allocation from USSMD negated the positive revenue variance. In fiscal year 1987, Applications had a Q87-3 burdened margin of 26.9% of net revenues and a year-to-date margin of 27.9%. Comparable figures for fiscal 1988 are 20.4% and 20.6% respectively.

Systems

The condensed burdened operating income statement for Systems for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$55,793	100.0%	$32,676	100.0%	$23,117
Cost of revenues	5,670	10.2	2,257	6.9	(3,413)
Operating expenses	6,798	12.2	6,172	18.8	(626)
Allocations - Research and development	465	0.9	449	1.4	(16)
Allocations - Sales and marketing	6,423	11.5	5,204	15.8	(1,219)
Allocations - General and administrative	1,011	1.7	861	2.6	(150)
Burdened operating income	$ 35,426	63.5%	$17,733	54.3%	$17,693

The condensed YTD burdened operating income statement for Systems through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$149,046	100.0%	$97,947	100.0%	$51,099
Cost of revenues	14,359	9.6	8,289	8.5	(6,070)
Operating expenses	17,924	12.0	17,532	17.9	(392)
Allocations - Research and development	1,327	0.9	1,321	1.4	(6)
Allocations - Sales and marketing	17,483	11.6	15,202	15.5	(2,281)
Allocations - General and administrative	2,930	1.9	2,573	2.6	(357)
Burdened operating income	$ 95,023	63.8%	$53,030	54.1%	$41,993

Systems net revenues by channel for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$ 3,533	6.3%	$ 2,291	7.0%	$ 1,242
International Retail	10,111	18.1	2,888	8.8	7,223
Domestic OEM	21,150	37.9	15,937	48.8	5,213
International OEM	20,163	36.1	10,909	33.4	9,254
Product Support	1,041	1.9	767	2.3	274
Discounts and rebates	(205)	(0.3)	(116)	(0.3)	(89)
	$55,793	100.0%	$32,676	100.0%	$23,117

In terms of revenue generation, the Systems commodity leading products (compared with plan) for the quarter were as follows:

Actual	Plan		Actual Units	Actual Revenue (in thousands)	Plan Units	Plan Revenue (in thousands)
1	1	MS-DOS/GW-Basic	2,060,211	$35,824	1,601,896	$24,414
2	2	Windows	456,532	7,463	228,504	5,056
3	3	Windows 386	90,101	3,658	26,724	1,567
				$46,945		$31,037
Percent of net revenues				84.1%		95.0%

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Table of significant Domestic OEM Systems customers, by product (in thousands):

	MS-DOS		Windows/Windows 386		Other		Total	
Zenith	$ 1,930	12.1%	$ 515*	12.4%	$ 105	9.5%	$ 2,550	12.1%
Compaq	1,983	12.6	379	9.1	-	-	2,362	11.2
AT&T	589	3.7	1,065*	25.6	5	0.5	1,659	7.8
Tandy	1,388	8.7	54*	1.3	40	3.6	1,482	7.0
Tandon	982	6.2	17	0.4	-	-	999	4.7
AST	911	5.7	-	-	-	-	911	4.3
NCR	798	5.0	-	-	3	0.3	801	3.8
Wyse	787	5.0	-	-	-	-	787	3.7
Hewlett Packard	9	0.1	519*	12.5	56	5.1	584	2.8
Wang	177	1.1	368	8.8	6	0.5	551	2.6
Alcatel	389	2.4	109	2.6	27	2.4	525	2.5
IBM	-	-	522	12.5	2	0.2	524	2.5
DEC	287	1.8	213	5.1	5	0.5	505	2.4
Thomson	420	2.6	-	-	32	2.9	452	2.1
Paterson Labs	420*	2.6	-	-	-	-	420	2.0
Commodore	414	2.6	-	-	-	-	414	2.0
GAAP Adjustment	-	-	-	-	(900)	(81.4)	(900)	(4.3)
UPB Allocations	-	-	-	-	1,523	137.7	1,523	7.2
Other Customers	4,401	27.8	398	9.7	202	18.2	5,001	23.6
Total	$15,885	100.0%	$4,159	100.0%	$1,106	100.0%	$21,150	100.0%
Licensing	$13,562	85.4%	$2,762	66.4%	$ 166	15.0%	$16,490	78.0%
Packaged Product	2,323	14.6	1,397	33.6	317	28.7	4,037	19.1
GAAP and UPB	-	-	-	-	623	56.3	623	2.9
Total	$15,885	100.0%	$4,159	100.0%	$1,106	100.0%	$21,150	100.0%
Plan	$13,362		$2,564		$ (9)		$15,937	

* Primarily packaged product

Table of significant International OEM Systems customers, by product (in thousands):

	MS-DOS		Windows/Windows 386		Other		Total	
Olivetti	$ 1,275	8.2%	$ 686	44.4%	$ 51	1.7%	$ 2,012	10.0%
Multitech Ind.	1,328	8.5	-	-	-	-	1,328	6.6
Matsushita Elec	955	6.1	21	1.4	-	-	976	4.8
Hitachi Ltd	861	5.5	-	-	-	-	861	4.3
Hyundai Elec.	776	5.0	-	-	-	-	776	3.8
Gold Star	743	4.8	-	-	-	-	743	3.7
Daewoo	675	4.3	-	-	-	-	675	3.3
Samsung Elec.	667	4.3	-	-	-	-	667	3.3
Epson	659	4.2	-	-	-	-	659	3.3
Toshiba	659	4.2	-	-	-	-	659	3.3
ASCII	-	-	-	-	560	18.3	560	2.8
Matsushita Comm	549	3.5	-	-	-	-	549	2.7
Philips Telecom	312	2.0	208	13.5	-	-	520	2.6
SMT Goupil	335	2.2	154	10.0	-	-	489	2.4
Sanyo Elec.	457	2.9	-	-	-	-	457	2.3
Bull S.A.	420	2.7	22	1.4	-	-	442	2.2
Siemens	41	0.3	-	-	400	13.1	441	2.2
Lyi-Cheng	432	2.8	-	-	-	-	432	2.1
GAAP Adjustment	-	-	-	-	900	29.4	900	4.5
UPB Allocations	-	-	-	-	1,113	36.4	1,113	5.5
Other Customers	4,417	28.5	453	29.3	34	1.1	4,904	24.3
Total	$15,561	100.0%	$1,544	100.0%	$3,058	100.0%	$20,163	100.0%
Plan	$10,100		$ 660		$ 149		$10,909	

The Systems commodity benefited from an overall favorable PC market, especially in the International arena. Net revenues were $55.8 million or 70.7% over the planned $32.7 million. On a year-to-date basis, revenues are 152.2% of plan ($149 million compared to $97.9 million).

International OEM contributed $9.3 million toward the variance, principally due to greater than planned revenues from MS-DOS ($5.5 million); Windows ($884,000); and OS/2 ($400,000); combined with $560,000 in MSX revenue from the ASCII settlement, UPB allocations of $1.1 million and the positive $900,000 GAAP adjustment. International Retail generated strong packaged MS-DOS and Windows sales which exceeded plan by $4.2 million and $932,000, respectively. International Retail also sold an unplanned $807,000 of packaged Windows 386 and $776,000 in OS/2 SDK's. The Domestic OEM channel contributed significantly to the overall variance via higher revenues from MS-DOS ($2.5 million), Windows 386 ($855,000), Windows ($610,000) and UPB allocations ($1.5 million). These favorable variances were slightly offset by the negative GAAP adjustment (-$900,000). As a result, our consolidated GAAP adjustment was zero. USSMD incurred a positive $1.2 variance due to higher sales levels of Windows 386, Windows updates and Windows ISV kits.

The unfavorable cost of revenues (both in terms of dollars and as a percent of revenue) was generated by the higher level of packaged product sales from International Retail and USSMD which respectively accounted for $1.8 million and $413,000 of the variance. The balance of the unfavorable variance resulted from manufacturing variances and inventory adjustments ($678,000) and "other" manufacturing costs ($400,000).

The increased revenue levels negatively impacted operating expenses by the corresponding increases in commissions to third-parties ($606,000), bad debt expense ($262,000) and taxes ($183,000). Additionally, third-party product development costs exceeded plan by $242,000. These unfavorable variances were partially negated by lower advertising and marketing expenses ($587,000) and payroll & payroll taxes ($195,000).

Allocations from the sales and marketing and general and administrative groups produced unfavorable variances of $1.2 million and $150,000, respectively. The sales and marketing variance resulted from the International OEM, PSS and International Retail pools exceeding plan. The allocation variance from general and administrative was due to the Corpcom overhead and Finance and Administration pools exceeding plan.

The strong revenue performance outweighed the negative variances in all expense categories, producing a burdened operating income of $35.4 million, 199.8% of plan. On a year-to-date basis, burdened operating income of $95 million exceeds plan by $42 million.

Languages

The condensed burdened operating income statement for Languages for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$15,392	100.0%	$11,335	100.0%	$4,057
Cost of revenues	4,666	30.3	2,245	19.8	(2,421)
Operating expenses	3,111	20.2	3,315	29.2	204
Allocations - Research and development	47	0.3	294	2.6	247
Allocations - Sales and marketing	3,118	20.2	2,491	22.0	(627)
Allocations - General and administrative	609	4.0	513	4.5	(96)
Burdened operating income	$ 3,841	25.0%	$ 2,477	21.9%	$1,364

The condensed burdened operating income statement for Languages for FY-88 March year-to-date follows (in thousands):

	Actual		Plan		Variance
Net revenues	$42,602	100.0%	$32,126	100.0%	$10,476
Cost of revenues	11,725	27.5	6,431	20.0	(5,294)
Operating expenses	9,622	22.6	10,084	31.4	462
Allocations - Research and development	603	1.4	856	2.6	253
Allocations - Sales and marketing	8,064	19.0	7,279	22.7	(785)
Allocations - General and administrative	1,754	4.1	1,538	4.8	(216)
Burdened operating income	$10,834	25.4%	$ 5,938	18.5%	$ 4,896

Languages revenues by channel for the quarter were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$ 8,981	58.3%	$ 6,799	60.0%	$ 2,182
International Retail	5,950	38.7	3,494	30.8	2,456
Domestic OEM	813	5.3	1,115	9.8	(302)
International OEM	250	1.6	242	2.1	8
Product Support	102	0.7	31	0.3	71
Rebates (mainly USSMD)	(704)	(4.6)	(346)	(3.0)	(358)
	$15,392	100.0%	$11,335	100.0%	$ 4,057

Net revenues for Q88-3 at $15.4 million were $4.1 million above plan. In comparison to the prior quarter, revenues decreased 14.1% from $17.6 million. All channel revenues (except Product Support Services) decreased in comparison to prior quarter's actuals. In terms of revenue generation, the commodity's leading products (compared with plan) for the quarter were as follows:

			Actual		Plan	
Q88-3	Q88-2		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	C Compiler (DOS)	30,525	$ 5,518	13,438	$3,172
2	-	Fortran	6,739	2,171	6,581	1,512
3	3	Macro Assembler	22,499	1,630	17,576	1,131
4	2	QuickBasic	25,312	1,413	26,205	1,389
5	5	Quick-C (DOS)	15,719	803	19,151	949
				$11,535		$8,153
Percentage of net revenues				74.9%		71.9%

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C Compiler was the No. 1 product for the second straight quarter with net revenue of $5.5 million resulting in an increase of 15% from $4.8 million in Q88-2. Shipments of C Compiler were discontinued in March pending a new software release (version 5.1). In Q88-3, the Languages division released several new versions of software for both the MS-DOS and OS/2 environments. These releases did not significantly affect Q88-3 since they were released late in the quarter. The following shows quarterly Language sales by operating system:

	DOS %	Mac %	Xenix %	Updates %	8-Bit OEM %	Other %
Q88-3	80.9	2.6	2.0	8.9	3.9	1.8
Q88-2	72.7	1.6	2.0	17.2	5.0	1.5
Q88-1	75.9	3.5	4.0	9.6	5.5	1.4
Q87-4	78.3	2.5	4.9	8.5	2.2	3.6
Q87-3	75.3	4.9	1.7	7.7	8.0	2.4

Cost of revenues of $4.7 million were $2.5 million above a plan of $2.2 million. As a percentage of sales, cost of revenues were 30.3% against a plan of 19.8%. Product costs (material, labor and overhead) continued to exceed forecast with an actual percentage of net revenues of 24.9% compared to a budgeted 14.4%. Other non-product costs included in cost of revenues as a percentage of net revenues were 5.4% compared to a plan of 5.3%. The standard cost of most major Language products (Fortran, Basic Compiler, QuickBasic, Macro Assembler, C Compiler and Quick C) were all significantly higher than budgeted. The increased media and documentation required to support both the MS-DOS and OS/2 environments is a key contributing factor in understanding this variance from budget. A relatively high proportion of "less than full price" sales (primarily updates and special deals) continued to contribute to lower than planned gross margins. In the case of USSMD's Q88-3 Language sales, updates were 11.2% of the total and produced a cost of goods to revenues ratio of 41.1%. Contrastingly, USSMD's finished good (full price) sales of Language products resulted in a 17.5% cost of goods to revenue relationship.

During Q88-3, Language operating expenses totalled $3.1 million against a planned $3.3 million. As a percentage of net revenues, operating expenses were 20.2% versus a planned 29.2%. Positive variances in advertising ($272,000 versus a planned $599,000), and product development ($175,000 versus a planned $444,000) were the most significant. Advertising expenditures were spread broadly over the Language product line. Advertising expenditures relating to the Christmas Promo of $67,000 came in lateduring Q88-3 ($270,000 year-to-date). In addition, $116,000 of year-to-date marketing material expenditures brings the Christmas Language Promo to a total cost of $386,000. Deferred expenditures for purchased code was the primary cause of the positive variance in product development. The largest negative operating expense variance was payroll and payroll taxes where actuals of $1.2 million were $101,000 over plan.

Allocations to Languages of $3.8 million were $475,000 over plan. The most significant negative variance resulted from this quarter's allocation from USSMD ($508,000 over plan). User Education allocations were $257,000 under plan as a result of a year-to-date adjustment to reflect actual benefits derived

Burdened operating income for Languages was $3.8 million (25.0% of net revenues) compared to a plan of $2.5 million (21.9% of net revenues). Net revenues were $4.1 over plan, cost of revenues and the sales and marketing allocation from USSMD were also greater than plan, resulting in a net $1.3 million favorable burdened operating income variance for Languages in Q88-3.

Hardware

The condensed burdened operating income statement for Hardware for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$19,226	100.0%	$11,727	100.0%	$7,499
Cost of revenues	10,931	56.9	5,707	48.7	(5,224)
Operating expenses	1,132	5.9	935	8.0	(197)
Allocations - Research and development	178	0.9	220	1.9	42
Allocations - Sales and marketing	3,316	17.2	2,664	22.7	(652)
Allocations - General and administrative	275	1.4	231	1.9	(44)
Burdened operating income	$ 3,394	17.7%	$ 1,970	16.8%	$ 1,424

The condensed burdened operating income statement for Hardware for FY-88 March year-to-date follows (in thousands):

	Actual		Plan		Variance
Net revenues	$44,636	100.0%	$33,523	100.0%	$11,113
Cost of revenues	24,765	55.5	16,370	48.8	(8,395)
Operating expenses	3,418	7.7	3,542	10.6	124
Allocations - Research and development	599	1.4	645	1.9	46
Allocations - Sales and marketing	8,549	19.1	7,783	23.2	(766)
Allocations - General and administrative	782	1.7	698	2.1	(84)
Burdened operating income	$ 6,523	14.6%	$ 4,485	13.4%	$ 2,038

Hardware revenues by channel for the quarter were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$11,960	62.2%	$ 7,137	60.9%	$4,823
International Retail	7,630	39.7	4,770	40.7	2,860
Domestic OEM	167	0.8	72	0.6	95
International OEM	-	-	-	-	-
Product Support Services	-	-	2	-	(2)
Rebates	(531)	(2.8)	(254)	(2.2)	(277)
	$19,226	100.0%	$11,727	100.0%	$7,499

In terms of revenue generation, Hardware's leading products (compared with plan) for the quarter were as follows (dollars in thousands):

	Actual		Plan		Variance
	Units	Dollars	Units	Dollars	
White (new) Mouse	136,157	$12,143	105,356	$10,197	$1,946
Bus Mouse	83,304	3,113	-	-	3,113
Serial Mouse	25,396	3,352	-	-	3,352
Inport Mouse - Retail	1,756	81	-	-	81
Inport Mouse - OEM	2,057	1	27,000	12	(11)
Subtotal Mouse	248,670	$18,690	132,356	$10,209	$8,481
Mach 10	1,442	106	-	-	106
Mach 20	2,233	583	7,378	1,708	(1,125)
Other - net of rebates	-	(153)	-	(190)	37
		$19,226		$11,727	$7,499

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Net revenues of $19.2 million were $7.5 million above plan of $11.7 million resulting in a record quarter. The reason for this favorable variance was the continuing higher than expected sales of the Mouse. This positive Mouse variance was slightly offset by Mach 20 shipments slipping into March. Strong Mouse sales accounted for $18.7 million of gross sales, $8.5 million over plan. The continued growth of graphics-oriented products, such as PC Excel and Windows, continued to encourage the high demand for the Mouse. We started the quarter with a $5.5 million Mouse backlog (65,549 units) and reduced it to $1.1 million (13,214 units). Originally forecast to bring in revenues of $1.7 million in Q88-3, the Mach 20 did not start shipping until March and generated only $583,000 in sales. Hardware marketing feels that with the late release of the Mach 20, we may have lost significant momentum in the add-on board market; as a result more cautious Mach 20 sales forecasts are being adopted. Hardware revenues through the USSMD channel were 67.6% over plan ($12.0 million versus $7.1 million), while Hardware revenues through the International Retail channel were 60.0% over plan ($7.6 million versus $4.8 million).

Cost of revenues was 56.9% of net revenues compared with a plan of 48.7%. Product costs (material, labor and overhead) as a percentage of net revenues were 45.9% compared to a plan of 40.7%. This variance is primarily due to higher than expected component and packaging costs for the White (new) Mouse. In addition, the use of dual media in this product was not anticipated in the budget. In March, Mach 10 finished goods were liquidated. The liquidation, at below product cost, resulted in a 0.8% increase in product cost of revenues as a percent of net revenues. All other items included in cost of revenues, as a percent of net revenues, were 11.0% compared to a plan of 8.0%. This variance was primarily due to inventory adjustments.

Hardware operating expenses during Q88-3 of $1.1 million exceeded plan by $196,000. Advertising expenses of $200,000 were 40.7% under budget of $337,000 due to continued slippage of International advertising for the new Mouse and Mach 20. Offsetting this favorable variance, were overruns in product development ($151,000 versus $44,000) payroll and payroll taxes, employee recruiting, travel and entertainment, and commissions.

Allocations to Hardware were $655,000 over a planned $3.1 million. The allocation of USSMD expenses of $2.3 million against plan of $1.7 million caused most of this variance.

Burdened operating income of $3.4 million (17.7% of net revenues) exceeded plan of $2.0 million (16.8% of net revenues) by $1.4 million. The $7.5 million positive net revenues variance (due to continued strong Mouse sales) was diluted somewhat by higher than anticipated costs of revenues.

Books

The condensed burdened operating income statement for Books for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$3,456	100.0%	$2,541	100.0%	$915
Cost of revenues	1,558	45.1	961	37.8	(597)
Operating expenses	986	28.5	806	31.7	(180)
Allocations - Sales and marketing	76	2.2	58	2.3	(18)
Allocations - General and administrative	148	4.3	137	5.4	(11)
Burdened operating income	$ 688	19.9%	$ 579	22.8%	$ 109

The condensed burdened operating income statement for Books for FY-88 March year-to-date follows (in thousands):

	Actual		Plan		Variance
Net revenues	$7,759	100.0%	$6,485	100.0%	$1,274
Cost of revenues	3,504	45.2	2,484	38.3	(1,020)
Operating expenses	2,830	36.5	2,574	39.7	(256)
Allocations - Sales and marketing	193	2.5	170	2.6	(23)
Allocations - General and administrative	434	5.5	401	6.2	(33)
Burdened operating income	$ 798	10.3%	$ 856	13.2%	$ (58)

Books revenues by channel of distribution for the quarter were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$ 358	10.4%	$ 184	7.2%	$ 174
OEM	1	-	-	-	1
International Retail	46	1.3	-	-	46
Press	3,072	88.9	2,364	93.0	708
Rebates	(21)	(0.6)	(7)	(0.2)	(14)
	$3,456	100.0%	$2,541	100.0%	$915

Net revenues for Q88-3 at $3.5 million exceeded plan of $2.5 million by 36%. This variance was due to sales of several new releases that exceeded expectations. Seven titles contributed $2.4 million (69.8% of net revenues) against a forecast of $1.2 million (47.9% of plan). For the fourth consecutive quarter, Running MS DOS, now in its 3rd edition, was the leading seller, contributing $1,048,000 or 30.3% of book commodity net revenues. Other top selling titles for the quarter were: MS-DOS Encyclopedia ($422,000; 98,191 copies), Inside OS/2 ($280,000; 36,964 copies), Advanced MS-DOS ($189,000; 12,416 copies), The Peter Norton Programmer's Guide ($169,000; 13,006 copies), and Programming Windows ($141,000; 11,194 copies). Inside OS/2 was initially released for distribution in January.

Actual cost of revenues was 45.1% of net revenues compared with a plan of 37.8%. Product costs (material, labor and overhead) as a percentage of net revenues were 21.2% compared with a plan of 16.1%. Product costs, especially the cost of paper, were higher than anticipated and resulted in this unfavorable variance. All other items included in costs of revenues (inventory, valuation adjustments, royalties, distribution costs and other) totalled 23.9% of net revenues compared with a plan of 21.7%. This variance was due to higher than anticipated freight costs and distribution fees.

Operating expenses of $986,000 exceeded plan of $806,000 by $180,000. As a percentage of net revenues, however, operating expenses were 28.5% compared with a plan of 31.7%. The majority of the unfavorable dollar variance fell in the marketing and product development categories. The cause of these variances was higher than anticipated development costs for the World of Math series, scheduled for release in the Fall of 1988, and several other books. In addition, unfavorable variances occurred in the building and grounds distribution ($39,000), payroll ($27,000), and general distribution ($25,000). Allocations to the Book commodity were higher than anticipated at $224,000 compared to plan of $195,000.

In summary, burdened operating income of $688,000 (19.9% of net revenues) was above plan of $579,000 (22.8% of net revenues). This favorable variance of $109,000 was the result of higher than anticipated sales offset by higher cost of revenues and operating expenses. Year-to-date income of $798,000 is below plan of $856,000 by $58,000. With the expected release of several new titles in Q88-4 and continued strong sales of existing titles, Q88-4 sales should exceed budget of $2.1 million.

Xenix

The condensed burdened operating income statement for Xenix for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$2,873	100.0%	$2,575	100.0%	$298
Cost of revenues	551	19.2	756	29.4	205
Operating expenses	695	24.2	682	26.5	(13)
Allocations - Research and development	13	0.4	12	0.5	(1)
Allocations - Sales and marketing	387	13.4	305	11.8	(82)
Allocations - General and administrative	85	3.0	77	3.0	(8)
Burdened operating income	$1,142	39.8%	$ 743	28.8%	$399

The condensed YTD burdened operating income statement for Xenix through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$6,746	100.0%	$6,496	100.0%	$250
Cost of revenues	2,079	30.8	1,919	29.5	(160)
Operating expenses	1,714	25.4	1,882	29.0	168
Allocations - Research and development	36	0.5	35	0.5	(1)
Allocations - Sales and marketing	1,052	15.6	888	13.8	(164)
Allocations - General and administrative	244	3.6	228	3.5	(16)
Burdened operating income	$1,621	24.1%	$1,544	23.7%	$ 77

Xenix net revenues by channel for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$ (3)	(0.1)%	$ –	–%	$ (3)
International Retail	77	2.7	–	–	77
Domestic OEM	2,218	77.2	1,750	67.9	468
International OEM	567	19.7	746	29.0	(179)
Product Support	14	0.5	79	3.1	(65)
	$2,873	100.0%	$2,575	100.0%	$298

Table of significant OEM Customers (in thousands):

	Actual		Plan		Variance
DOMESTIC OEM					
SCO	$1,247	56.2%	$ 720	41.1%	$ 527
IBM	360	16.2	–	–	360
Altos	257	11.6	447	25.5	(190)
Intel	118	5.3	53	3.0	65
Lanier	65	2.9	**	–	65
Tandy	37	1.7	162	9.3	(125)
Wang	31	1.4	231	13.2	(200)
Interactive Systems	24	1.1	105	6.0	(81)
Other Customers	79	3.6	32	1.9	47
Total	$2,218	100.0%	$1,750	100.0%	$ 468
INTERNATIONAL OEM					
Toshiba	$257	45.3%	$ –	–%	$ 257
Siemens	107	18.9	110	14.7	(3)
Apricot	95	16.8	–	–	95
Northern Telecom	39	6.9	**	–	39
Hindustan	25	4.4	**	–	25
SMT Goupil	21	3.7	9	1.2	12
Other Customers	23	4.0	627	84.1	(604)
Total	$567	100.0%	$746	100.0%	$(179)

** Customer not individually forecasted.

Net revenues for the quarter were $2.9 million, or 111.6% of the planned $2.6 million. On a year-to-date basis, net revenues are 103.8% of plan ($6.7 million versus $6.5 million).

The Domestic OEM channel generated a $468,000 favorable revenue variance for the quarter, primarily due to SCO reporting a record $1.2 million in royalties ($527,000 over plan) and IBM submitting $354,000 in previously unreported royalties. These were partially offset by less than anticipated royalties from Wang ($200,000), Altos ($190,000) and Tandy ($125,000). International OEM contributed a net $179,000 negative variance. Toshiba and Apricot generated unforecasted revenue of $257,000 and $95,000, respectively. However, this was more than offset by a $483,000 negative variance from Mitsubishi, resulting from lower than anticipated sales of Xenix-based machines to Unisys, combined with a contract amendment which reduced previously reported royalties. The Product Support channel shortfall resulted from fewer Xenix related courses taught than planned.

The favorable $205,000 cost of revenues variance was primarily the net result of a favorable $506,000 variance from International OEM channel and an unfavorable $270,000 variance from the Domestic OEM channel. Both are related to Xenix royalties and second sourcing (support) costs. The International OEM component resulted from an adjustment to decrease the accrual for such expenses in order to bring it in line with the actual liability existing at the end of the quarter. The Domestic OEM portion stemmed from higher than planned Xenix revenue for that channel.

Operating expenses were essentially at planned levels ($695,000 compared with $682,000). No significant individual variances were incurred. The unfavorable sales and marketing allocations variance was due to the International OEM and PSS pools exceeding plan.

The favorable revenue and cost of revenue variances outweighed the minor unfavorable variances in direct and allocated expenses, producing a burdened operating income of $1.1 million, 153.7% of plan. On a year-to-date basis, the commodity is at 105% of plan, with burdened operating income of $1.6 million.

CD ROM Commodity

The condensed burdened operating income statement for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$269	100.0%	$1,815	100.0%	$(1,546)
Cost of revenues	98	36.4	97	5.3	(1)
Operating expenses	886	329.4	853	47.0	(33)
Allocations - Research and development	(209)	(77.5)	152	8.3	361
Allocations - Sales and marketing	89	33.1	140	7.7	51
Allocations - General and administrative	118	43.4	105	5.9	(13)
Burdened operating income (loss)	$(713)	(264.8)%	$ 468	25.8%	$(1,181)

The condensed YTD burdened operating income statement through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$1,552	100.0%	$3,305	100.0%	$(1,753)
Cost of revenues	393	25.3	272	8.2	(121)
Operating expenses	2,356	151.8	2,359	71.4	3
Allocations - Research and development	74	4.8	437	13.2	363
Allocations - Sales and marketing	230	14.9	409	12.4	179
Allocations - General and administrative	339	21.8	314	9.5	(25)
Burdened operating loss	$(1,840)	(118.6)%	$ (486)	14.7%	$(1,354)

CD ROM net revenues by channel for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
USSMD	$ 26	9.5%	$ 150	8.3%	$ (124)
International Retail	(45)	(16.6)	-	-	(45)
Domestic OEM	236	87.7	261	14.4	(25)
International OEM	8	2.8	1,021	56.2	(1,013)
CD ROM	63	23.2	375	20.6	(312)
Product Support	2	0.8	12	0.7	(10)
Discounts and rebates	(21)	(7.4)	(4)	(0.2)	(17)
	$269	100.0%	$1,815	100.0%	$(1,546)

The CD ROM channel handles the Beta Partner Agreements and the EIKON joint venture. Domestic OEM receives credit for sales of Bookshelf to Amdek, while retail Bookshelf is distributed through both USSMD and International Retail. MS-DOS Extensions are marketed by both Domestic OEM and International OEM.

In terms of revenue generation, the CD ROM commodity leading products (compared with plan) for the quarter were as follows:

			Actual		Plan	
Current Quarter	Prior Quarter		Units	Revenue (in thousands)	Units	Revenue (in thousands)
1	1	Bookshelf	2,568	$180	4,000	$ 411
2	2	Beta Partner Agreements	1	63	3	375
3	3	MS-DOS Extensions	20,539	44	8,500	21
-	-	EIKON Joint Venture	-	-	-	1,000
-	-	Discounts and rebates	-	(20)	-	(4)
				$267		$1,803
Percent of net revenues				99.3%		99.3%

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CD ROM revenues were under plan by $1.5 million. The major contributing factors were no revenue from the EIKON joint venture (International OEM channel - $1 million), lower than anticipated revenue from the Beta Partner program (CD ROM channel - $312,000) and the low level of retail Bookshelf sales (USSMD channel - $124,000). The agreement concerning EIKON's license of Bookshelf, Browser and Authoring Tools has not yet materialized. Recognition of Beta Partner revenue is deferred until our obligations under the individual agreements are fulfilled. Such deferral was not foreseen by the plan. This, combined with a change in strategy to postpone the pursuit of new Beta Partnership opportunities, resulted in the above mentioned shortfall. However, at the end of the quarter, a total of $187,500 remains as deferred revenue and will be recognized in future periods. The EIKON and Beta Partnership factors are the main force behind the unfavorable year-to-date revenue variance ($1.6 million compared with a $3.3 million plan).

Cost of revenues of $98,000 was right at plan despite the overall lower Bookshelf sales. The anticipated savings in this area were offset by unfavorable royalty expense and manufacturing variances ($17,000 and $10,000, respectively). The royalty variance was due to $27,000 in previously unrecorded Bookshelf royalties for calendar year 1987.

The net unfavorable operating expense variance of $33,000 was principally the result of higher product development costs ($120,000). This was largely offset by below planned levels of advertising ($21,000), travel & entertainment ($20,000), recruiting ($17,000) and payroll related expenses ($10,000) in addition to several other insignificant favorable variances. Net negative allocated research and development expenses ($209,000) stemmed from a year-to-date adjustment of the User Education allocation to reflect reality. The $51,000 favorable sales and marketing allocation resulted from a below plan International OEM pool.

In summary, the revenue shortfall outweighed the net favorable expense variances, causing the $713,000 burdened operating loss against a planned income of $468,000. On a year-to-date basis, the commodity has a burdened operating loss of $1.8 million compared with a planned loss of $486,000.

Networks

The condensed burdened operating income statement for Networks for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 718	100.0%	$ 334	100.0%	$384
Cost of revenues	–	–	–	–	–
Operating expenses	1,629	227.1	792	237.2	(837)
Allocations - Research and development	3	0.4	3	0.9	–
Allocations - Sales and marketing	63	8.7	51	15.1	(12)
Allocations - General and administrative	91	12.7	86	25.7	(5)
Burdened operating loss	$(1,068)	(148.9)%	$(598)	(178.9)%	$470

The condensed YTD burdened operating income statement for Networks through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 1,545	100.0%	$ 902	100.0%	$643
Cost of revenues	–	–	10	1.1	10
Operating expenses	2,892	187.1	2,177	241.2	(715)
Allocations - Research and development	9	0.6	9	1.0	–
Allocations - Sales and marketing	173	11.2	148	16.5	(25)
Allocations - General and administrative	264	17.2	251	27.9	(13)
Burdened operating loss	$(1,793)	(116.1)%	$(1,693)	(187.7)%	$(100)

Networks net revenues by channel for Q88-3 were as follows (in thousands):

	Actual		Plan		Variance
Domestic OEM	$528	73.5%	$142	42.5%	$386
International OEM	189	26.4	184	55.1	5
Product Support	1	0.1	8	2.4	(7)
	$718	100.0%	$334	100.0%	$384

Networks revenue for the quarter exceeded plan by $384,000 (115%) as a result of both Domestic OEM and International OEM channels generating favorable volume variances of the MS NET product. Domestic OEM's reported 44,000 units against a plan of 14,000. International OEM's reported 19,000 units compared to the planned 13,500. The most significant customers were DEC (17,800 units for $214,000), Ungermann-Bass (12,200 units for $102,000), Research Machines, Ltd. (13,400 units for $82,000), 3Com (5,000 units for $81,000) and IBM-Japan (1,700 units for $61,000).

No cost of revenues was recorded since all of the revenue was royalty related. The main contributors to the negative operating expense variance of $837,000 were higher than planned expenses for payroll ($358,000), supplies and equipment ($104,000), public relations and trade shows ($104,000) and employee recruiting ($80,000). Nearly all other expense categories also exceeded plan, but by less significant amounts. Larger than planned International OEM and PSS pools accounted for the unfavorable sales and marketing allocation ($12,000).

In summary, the positive results in net revenues were not enough to offset unfavorable variances in direct and allocated expenses, producing a burdened operating loss of $1.1 million compared to a planned loss of $598,000. On a year-to-date basis, the net operating loss for the commodity is only 5.9% above the plan ($1.8 million versus $1.7 million). Networks was planned to incur operating losses of between $500,000 and $600,000 in each quarter of FY'88.

MS Systems Journal

The condensed burdened operating income statement for MS Systems Journal commodity for Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 668	100.0%	$ 558	100.0%	$ 110
Cost of revenues	167	25.0	204	36.6	37
Operating expenses	519	77.7	321	57.5	(198)
Allocations - General and administrative	39	5.8	38	6.9	(1)
Burdened operating income	$ (57)	(8.5)%	$ (5)	(1.0)%	$ (52)

The condensed burdened operating income statement for MS Systems Journal through Q88-3 follows (in thousands):

	Actual		Plan		Variance
Net revenues	$ 1,368	100.0%	$ 1,631	100.0%	$ (263)
Cost of revenues	447	32.7	484	29.7	37
Operating expenses	1,351	98.8	927	56.8	(424)
Allocations - General and administrative	110	8.0	112	6.8	2
Burdened operating income	$ (540)	(39.5)%	$ 108	6.7%	$ (648)

MS Systems Journal net revenue for Q88-3 was $110,000 above plan of $558,000. The favorable variance was primarily due to new subscriptions generated through the Canadian Promotional mailing. This mailing, planned for Q88-2, was delayed by the Canadian Postal strike. The actual subscribers list declined by 3,000 during Q88-3 from 36,000 to 33,000. This decrease is due to the expiration of the publication's initial one year subscriptions. Promotional material, designed to generate renewals, is currently being mailed. The expected renewal rate is 65% to 70%. It is estimated that the subscribers list will exceed 40,000 by June 30, 1988. It should be noted, that since Systems Journal revenue is reported on a cash basis, revenue can increase from quarter to quarter even as the number of subscription decreases.

Actual cost of revenues was $167,000 compared to plan of $204,000 Cost of revenues is understated by a $97,000 charge for mailing the Journal to subscribers. This cost was coded to postage rather than cost of revenues and will be reclassified in April. On a restated basis, cost of revenues of $264,000 exceeded plan by $60,000. Year-to-date cost of revenues, restated, is $544,000 (39.8% of net revenues)versus plan of $484,000 (29.7% of net revenues). The unfavorable variances are due to higher than expected paper costs. Cost of revenues are relatively fixed for Systems Journal. MSJ has not changed production quantities though subscriptions are below plan because small print runs are not significantly less costly than large runs (in absolute terms). The resulting excess copies are being used for promotional purposes.

Operating expenses of $519,000 exceeded plan of $321,000 by $198,000. This variance is the result of large variances in administrative services, postage and product development. Administrative services, primarily representing the cost of our subscription processing service, was $56,000 over budget. This is due to a poor estimate of the actual service fees. As previously stated, postage for the quarter, $129,000, includes a $97,000 charge for mailing the Journal to subscribers. This will be reclassified in April. Product development of $35,000 (primarily payments to authors for Microsoft Systems Journal articles) exceeded budget by $23,000.

Allocations to the Systems Journal approximated plan at $39,000. Due to stable headcount, Systems Journal allocations (general and administrative only) are near budget for the year-to-date as well, $110,000 versus a plan of $112,000.

In summary, the Q88-3 burdened operating loss of $57,000 was higher than a planned loss of $5,000. Year-to-date, the burdened operating loss of $540,000 compares to a planned net income of $108,000. Renewals are the key to the publication's operating results for the year ended June 30, 1988. If the estimated 65% to 70% renewal rate is accurate, the net revenue budget of $544,000 for Q88-4 should be achieved. It is unlikely, however, that budgeted revenue for the year will be met. As expenses continue to exceed plan, it does not appear that the burdened operating loss will improve significantly by year-end. On the positive side, distribution of the Journal in Europe will be in place for Q88-4, resulting in additional revenue. These two factors, along with strong renewals, should result in a break-even quarter for Q88-4.

FINANCIAL CONDITION

FINANCIAL CONDITION

Microsoft turned in a very strong financial performance in the third quarter. Nonetheless, from the quarter-to-quarter changes in the key measures of financial strength as depicted in the table below, it would appear that the performance was less than uniformly solid. However, one should bear in mind that the second quarter, also, was very strong. In this light, the $41.6 million in cash flow from operations is excellent and the $1.9 million increase stems primarily from the increase in sales combined with the 0.4% widening of the net income margin. Working capital increased $30.5 million, or 15.3%, which reflects the reduction of notes payable by $21.8 million and the increase of inventory by $14.3 million. Moreover, this shift in the composition of working capital played a major role in the significant increase in both the current and quick (acid) ratios from 2.9 and 2.6 last quarter to 3.5 and 3.0, respectively this quarter. Cash and short-term investments are a deceiving indicator this quarter because of the unusual cash flows. Not only did the corporation payoff $21.8 million of hedge loans, but also it acquired $16.1 million of additional plant and equipment. Nevertheless, cash declined by only $1.1 million, a manifestation of the cash generating power of Microsoft. Total assets grew $28.9 million to $440.7 million, principally as a result of the previously mentioned $14.3 million increase in inventory and the $16.1 million expansion of plant and equipment. Finally, stockholders' equity grew 14.1% to $343.2 million which reflects the contribution of net income and $6.7 million of income tax benefit related to the stock option bonus (NQSO conversion) programs.

MEASURES OF FINANCIAL STRENGTH
(dollars in millions)

	Q88-3	Q88-2	Change	% Change
Cash flow from operations	$ 41.6	$ 39.7	$ 1.9	4.8
Working capital	229.2	198.7	30.5	15.3
Cash and short-term investments	181.5	182.6	(1.1)	(0.6)
Total assets	440.7	411.8	28.9	7.0
Stockholders' equity	343.2	300.9	42.3	14.1

Despite the slight decline from the second quarter in all of the following growth indicators, save net revenues, the rates of return achieved by Microsoft are outstanding by any measure. The declines result from the fact that the net income thrown off from operations is increasing at a slower rate than the equity and assets are expanding. As usual with Microsoft, the rates of return realized on the Company's non-cash equity and non-cash assets are very respectable.

GROWTH INDICATORS

Return On:	Q88-3*	Q88-2*	Q88-1*
Equity	46.3%	50.2%	33.9%
Assets	35.0%	37.4%	26.9%
Non-cash equity	106.6%	123.7%	79.5%
Non-cash assets	61.1%	67.2%	49.1%
Net revenues	23.1%	22.7%	20.7%

* annualized

For Q88-3, book value per share increased 13.4% (annualized rate of 53.6%) to $6.43, while shares outstanding increased 0.6% or 329,266 shares to 53,407,419 shares.

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Consolidated balance sheets as of March 31, 1988, December 31, 1987 and June 30, 1987 are presented below (in thousands).

	Mar. 31 1988	Dec. 31 1987	Quarter Change	Quarter % Change	June 30 1987	YTD Change	YTD % Change
ASSETS							
Current assets:							
Cash and short-term investments	$181,521	$182,600	$(1,079)	(0.6)	$132,484	$ 49,037	37.0
Accounts receivables - net	86,195	82,884	3,311	4.0	55,131	31,064	56.3
Inventories	42,955	28,642	14,313	50.0	16,555	26,400	159.5
Other	11,830	11,189	641	5.7	8,832	2,998	33.9
Total current assets	322,501	305,315	17,186	5.6	213,002	109,499	51.4
Property, plant and equipment - net	100,226	87,260	12,966	14.9	70,010	30,216	43.2
Intellectual property rights - net	9,193	10,353	(1,160)	(11.2)	-	9,193	-
Other assets	8,806	8,882	(76)	(0.9)	4,742	4,064	85.7
TOTAL	$440,726	$411,810	$28,916	7.0	$287,754	$152,972	53.2
LIABILITIES AND STOCKHOLDERS' EQUITY							
Current liabilities:							
Accounts payable	$ 31,029	$ 25,105	$ 5,924	23.6	$ 20,526	$ 10,503	51.2
Customer deposits and deferred revenue	8,240	6,198	2,042	32.9	6,289	1,951	31.0
Accrued compensation and employee benefits	13,463	11,455	2,008	17.5	5,127	8,336	162.6
Notes payable	11,034	32,844	(21,810)	(66.4)	5,172	5,862	113.3
Income taxes payable	17,062	17,547	(485)	(2.8)	2,217	14,845	669.6
Other	12,497	13,438	(941)	(7.0)	7,313	5,184	70.9
Total current liabilities	93,325	106,587	(13,262)	(12.9)	46,644	46,681	100.1
Long-term liabilities	4,210	4,351	(141)	(3.2)	2,005	2,205	110.0
Stockholders' equity:							
Common stock	53	53	-	-	53	-	-
Paid-in capital	86,304	80,092	6,212	7.8	76,811	9,493	12.4
Retained earnings	255,002	217,694	37,308	17.1	161,106	93,896	58.3
Translation adjustment	1,832	3,033	(1,201)	(40.0)	1,135	697	61.4
Total stockholders' equity	343,191	300,872	42,319	14.1	239,105	104,086	43.5
TOTAL	$440,726	$411,810	$28,916	7.0	$287,754	$152,972	53.2

Consolidated statements of changes in financial position for the three months and nine months ended March 31, 1988 and 1987 are presented below (in thousands).

	Three Months Ended March 31		Nine Months Ended March 31		
	1988	1987	1988	1987	
WORKING CAPITAL PROVIDED:					
Operations:					
Net income	$ 37,308	$ 19,101	$ 93,896	$ 54,622	1
Depreciation of property, plant and equipment	3,084	2,000	8,870	5,168	6
Amortization of intellectual property rights	1,160	-	2,865	-	
Total from operations	41,552	21,101	105,631	59,787	
Common stock issued	(515)	10,040	1,377	~~11,440~~	2,467
Income tax benefit related to stock option plans	6,728	-	8,117	-	8,962
Long-term liabilities	(141)	100	2,205	156	
Translation adjustment	(1,201)	1,604	697	~~2,394~~	2,390
Total working capital provided	46,423	32,845	118,027	73,782	2
WORKING CAPITAL USED:					
Additions to property, plant and equipment	16,051	5,735	39,087	17,204	
Acquisition of intellectual property rights	-	-	12,058	-	7
Other	(76)	(1,079)	4,064	(155)	
Total working capital used	15,975	4,656	55,209	17,049	7
INCREASE IN WORKING CAPITAL	30,448	28,189	62,818	56,734	5
WORKING CAPITAL, Beginning of Period	198,728	146,997	166,358	118,452	
WORKING CAPITAL, End of Period	$229,176	$175,186	$229,176	$175,186	7
CHANGES IN ELEMENTS OF WORKING CAPITAL:					
Current assets - increase (decrease):					
Cash and short-term investments	$ (1,079)	$ 23,425	$ 49,037	$ 40,121	
Accounts receivables - net	3,311	10,584	31,064	22,623	
Inventories	14,313	(213)	26,400	6,210	
Other	643	3,310	3,000	7,339	
Current liabilities - (increase) decrease:					
Accounts payable	(5,924)	1,327	(10,503)	~~(3,215)~~	(6,789)
Notes payable	21,811	(5,620)	(5,861)	~~(8,181)~~	(5,620)
Income tax payable	485	(3,793)	(14,845)	(2,946)	
Other	(3,112)	(831)	(15,474)	~~(6,217)~~	(4,203)
INCREASE IN WORKING CAPITAL	$ 30,448	$ 28,189	$ 62,818	$ 56,734	5

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Cash and Short-Term Investments

As previously noted, cash and short-term investments (at cost) decreased $1.1 million to $181.5 million during the third quarter of FY88. These liquid assets comprise 56.3% of current assets and 41.2% of total assets. As of quarter-end, the portfolio consisted of the security types listed below (also, see the accompanying pie chart and detailed listing of securities on the following pages):

	$ in Millions			
Security	Domestic	International	Total	Percent
Cash and Money Market Funds	$ (2.4)	$ 13.3	$ 10.9	6.0%
Bank Loan Participations	2.0	-	2.0	1.1
Increasing Rate Notes	16.0	16.9	32.9	18.1
Corporate Bonds	4.8	-	4.8	2.7
Money Market Preferreds	73.6	-	73.6	40.6
Euro $, CD's, Bank Bills	5.0	1.4	6.4	3.5
Municipal Securities	50.9	-	50.9	28.0
	$149.9	$31.6	$181.5	100.0%

In an attempt to quantify the value added to investment income by the treasury department for the third quarter, two series of financial data have been compiled (see tables I & II below) which compare the actual investment income realized from the principal types of securities in the portfolio with three "naive", alternative investment strategies. From table II below, it can be seen that our actual investment results were 76% better than investing only in overnight repurchase agreements at First Interstate; 69% better than investing only in 90-day treasury bills; and 38% better than investing only at 90-day libor rates. Of particular interest are the wide margins by which increasing rate notes (128%), money market preferreds (61%), and municipal securities (72%) have outperformed the overnight repo strategy. For comparative purposes, the dollar amounts listed in table I in the money market preferred and municipal security categories have been grossed up to reflect their pretax equivalents.

In summary, during the third quarter, the investment portfolio has generated $2.9 million of investment income on a worldwide basis which, when translated into equivalent after-tax income, using a marginal tax rate of 34%, amounts to $2.5 million, which is 6.8% of the Company's total net income, or 4.5 cents per share.

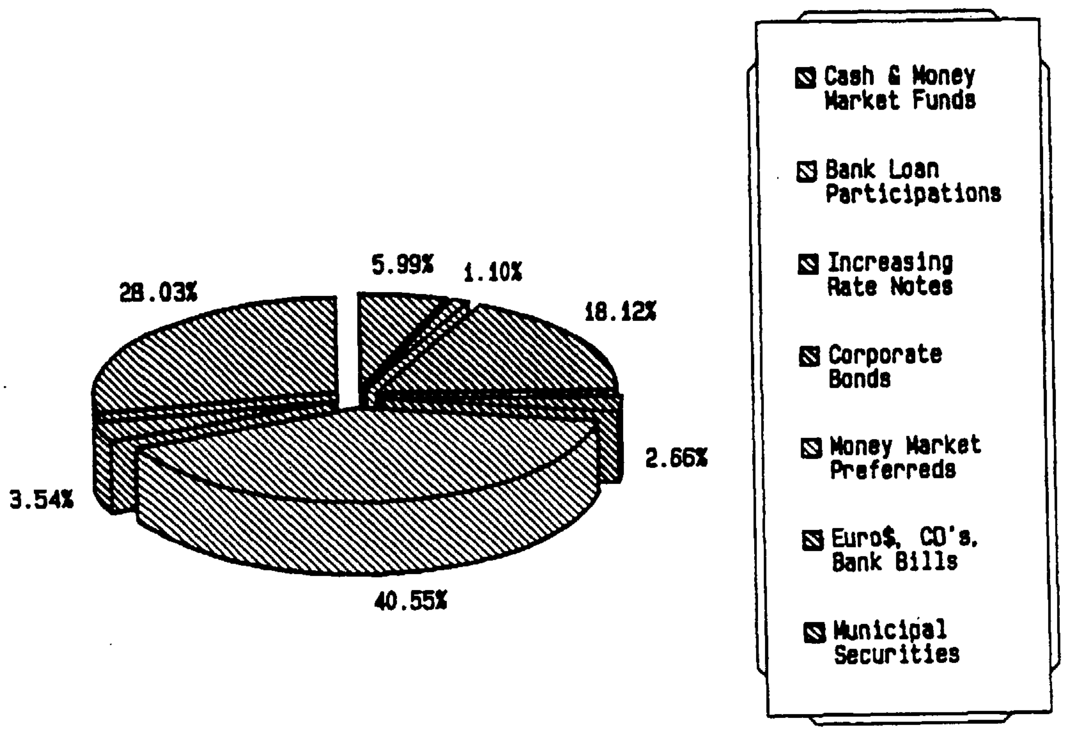
TABLE 1
Comparative Investment Incomes from 4 Investment Strategies
for the Third Quarter of FY88 (Results Reflect Pre-tax Equivalents)

	90-Day Libor	90-Day T-Bill	Overnight Repo	Actual
Overnight Repurchase Agreements	$ 23,810	$ 19,906	$ 19,560	$ 19,560
Commercial Paper & Bank Loan Participations	104,573	86,767	82,358	107,265
Increasing Rate Notes	590,177	470,993	462,578	1,054,465
Money Market Preferreds	1,492,430	1,213,235	1,156,215	1,862,935
Municipal Securities	651,184	550,470	527,423	908,060
TOTAL	$2,862,174	$2,341,371	$2,248,134	$3,952,285

TABLE 2
Comparative Percentages by which Actual Investment Income Over or Under
Performed 3 Alternative Investment Strategies for the Third Quarter of FY88

	90-Day Libor	90-Day T-Bill	Overnight Repo
Overnight Repurchase Agreements	(18)%	(2)%	0%
Commercial Paper & Bank Loan Participations	3	24	30
Increasing Rate Notes	79	124	128
Money Market Preferreds	25	54	61
Municipal Securities	39	65	72
TOTAL	38	69	76

Investment Portfolio
March 31, 1988



Total Investments

Domestic	$149.9 M
International	31.6
	$181.5 M

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MICROSOFT CORPORATION
Domestic Investment Portfolio
As of March 31, 1988

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
Cash	N/A	N/A	($4,497,587)	-2.48%	N/A
Euro Dollar Deposits					
1 WestPac Banking Corportation	Apr 1, 88	6.813%	5,025,000	2.77%	N/A
			5,025,000	2.77%	
Money Market					
1 Continental Savings Bank	Apr 1, 88	6.900%	2,000,000	1.10%	N/A
			2,000,000	1.10%	
Corporate Bonds					
1 Central Maine Power	May 1, 88	10.850%	548,600	0.30%	BAA1/BBB+
2 Central Maine Power	May 1, 88	9.250%	1,100,000	0.61%	BAA1/BBB+
3 Commonwealth Edison	May 15, 88	9.131%	1,092,450	0.60%	BAA1/BBB
4 Commonwealth Edison	May 15, 88	9.152%	1,091,640	0.60%	BAA1/BBB
5 Citicorp	Dec 1, 88	8.600%	1,001,460	0.55%	A1/AA
			4,834,150	2.66%	
Loan Participation					
1 Unisys finance	Apr 4, 88	6.750%	2,000,000	1.10%	A2/P2
			2,000,000	1.10%	
Increasing Rate Notes					
1 Marcade Group	Apr 1, 88	13.5000%	1,000,000	0.55%	N/R
2 TWA	Apr 1, 88	15.0000%	2,000,000	1.10%	N/R
3 Goodson Newspapers Group	Apr 15, 88	14.5000%	1,965,000	1.08%	N/R
4 R-C Holdings Senior A	Apr 15, 88	12.3750%	1,500,000	0.83%	N/R
5 R-C Holdings Subordinated	Apr 15, 88	13.3750%	500,000	0.28%	N/R
6 Uniroyal-Plastics	May 1, 88	13.3750%	4,005,000	2.21%	N/R
7 Community Newspapers	Jun 1, 88	12.5000%	1,000,000	0.55%	N/R
8 Stone Forest Industries	Jun 15, 88	12.0625%	2,000,000	1.10%	N/R
9 Neoax, Inc.	Jul 1, 88	12.3750%	1,997,500	1.10%	N/R
			$15,967,500	8.80%	

MICROSOFT CORPORATION
Domestic Investment Portfolio
As of March 31, 1988

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
Municipal Securities - 100%Tax Free					
1 Denver, CO..City & Cnty TAN	Apr 1, 88	5.7670%	1,502,865	0.83%	MIG 2
2 Monroe Cnty, N.Y.	Apr 1, 88	4.7500%	743,453	0.41%	AA
3 Snohomish,Cty. WA. Pilchuck	Apr 1, 88	5.1000%	2,000,000	1.10%	A1
4 Utah Muni Fin Co-op	Apr 1, 88	6.2650%	1,990,000	1.10%	SP1+
5 Houston, Tx. Trans.	Jun 1, 88	7.0000%	986,720	0.54%	MIG 1
6 Everett, Wa . LID #713	Jun 1, 88	5.8750%	1,000,000	0.55%	N/R
7 Albia,Iowa	Jun 1, 88	5.0000%	1,097,635	0.60%	N/R
8 Los Angeles,Cnty. CA. Transportation	Jun 30, 88	6.0000%	1,967,700	1.08%	MIG 1
9 N.J. Econ Dev. Auth.-Ocean Spray	Jul 1, 88	5.0000%	1,997,680	1.10%	A+
10 Washington St. Health Care Facility	Jul 1, 88	5.0000%	924,177	0.51%	N/R
11 Antelope Valley	Jul 14, 88	7.5500%	977,200	0.54%	MIG 1
12 Redmond, Washington LID #85-ST-48	Jul 15, 88	6.0000%	1,392,160	0.77%	N/R
13 San Diego,Cnty. CA.	Aug 1, 88	6.2000%	1,964,100	1.08%	MIG 1
14 San Diego	Aug 1, 88	4.7300%	10,368,384	5.71%	MIG 1
15 Pueblo, CO. GAN's	Nov 1, 88	6.2480%	498,750	0.27%	N/R
16 New Hampshire IDA-Timco	Nov 1, 88	7.5000%	994,850	0.55%	A
17 White Bear Lk. Maj. Pine, MN.	Nov 1, 88	7.0000%	1,000,000	0.55%	N/R
18 Clairborne, MISS. PCR	Dec 1, 88	8.2500%	5,000,000	2.75%	BAA1/BBB
19 Memphis City Center	Dec 1, 88	7.0000%	2,280,000	1.26%	SP 3
20 Sitka, Alaska BANS	Dec 1, 88	6.3000%	1,199,628	0.66%	N/R
21 Louisiana Pub. Fac. Auth	Dec 1, 88	6.3000%	1,980,000	1.09%	VMIG 1
22 Knox cnty. Tenn.	Dec 15, 88	7.3750%	2,000,000	1.10%	N/R
23 Washington St. HSG Auth.	Jan 1, 89	5.6000%	2,000,000	1.10%	N/R
24 Bremerton, WA.	Jan 13, 89	5.7500%	1,500,000	0.83%	A
25 Camden Cnty, N.J.	Jan 15, 89	4.9010%	994,610	0.55%	SP1+
26 Witchita, Ks.-Ramada Inn	Mar 1, 89	6.0000%	1,000,000	0.55%	N/R
27 Everett, Wa . LID #726	Aug 1, 89	5.6250%	1,000,000	0.55%	N/R
28 Memphis, Tenn.	Aug 1, 89	5.5190%	520,800	0.29%	AA
			50,880,712	28.03%	

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MICROSOFT CORPORATION
Domestic Investment Portfolio
As of March 31, 1988

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
Money Market Preferred - 70% Tax Free					
1 Nevada Power	Apr 1, 88	5.450%	2,000,000	1.10%	A3/A-
2 Heller Finance A	Apr 1, 88	5.590%	1,000,000	0.55%	A3/A-
3 Heller Fin "A"	Apr 1, 88	5.5900%	2,600,000	1.43%	A3/A-
4 Empire of America C	Apr 4, 88	5.600%	1,000,000	0.55%	AAA/AAA
5 ANA Hotel Cap.	Apr 4, 88	5.450%	1,000,000	0.55%	AAA/AAA
6 Empire of America C	Apr 4, 88	5.600%	2,000,000	1.10%	AAA/AAA
7 Citicorp 6A	Apr 4, 88	5.6400%	2,000,000	1.10%	A2/A+
8 Dime Funding I	Apr 5, 88	5.500%	1,000,000	0.55%	AAA/AAA
9 Cleveland Electric	Apr 5, 88	8.500%	1,000,000	0.55%	BAA2/BB+
10 Arvin Industries	Apr 5, 88	6.3000%	2,000,000	1.10%	BAA/BBB
11 Talman Finance B	Apr 5, 88	5.5900%	1,000,000	0.55%	AAA/AAA
12 Citicorp 5A	Apr 6, 88	5.6000%	1,000,000	0.55%	A2/A+
13 Empire of America	Apr 6, 88	5.5600%	500,000	0.28%	AAA/AAA
14 Union Bancorp	Apr 11, 88	5.970%	1,000,000	0.55%	A1/BBB
15 Carteret	Apr 12, 88	5.700%	2,000,000	1.10%	AAA/AAA
16 Florida Federal	Apr 12, 88	5.699%	2,000,000	1.10%	AAA/AAA
17 Cleveland Electric	Apr 12, 88	8.450%	2,000,000	1.10%	BAA2/BB+
18 Arvin Industries	Apr 12, 88	6.1250%	400,000	0.22%	BAA/BBB
19 Chrysler A	Apr 14, 88	5.750%	1,000,000	0.55%	BBB/BBB
20 Heller Finance B	Apr 15, 88	5.550%	2,000,000	1.10%	A3/A-
21 Par Fund	Apr 15, 88	7.500%	1,014,250	0.56%	N/A
22 Louis Dreyfus	Apr 18, 88	5.520%	1,000,000	0.55%	AAA/AAA
23 Ultramar B	Apr 20, 88	5.520%	2,000,000	1.10%	AAA
24 Chrysler	Apr 21, 88	5.800%	1,000,000	0.55%	BBB/BBB
25 Union Texas Petroleum A	Apr 26, 88	5.520%	1,000,000	0.55%	AAA/AAA
26 Golden Tulip KLM	Apr 26, 88	5.500%	1,000,000	0.55%	AAA/AAA
27 Puget Power A	Apr 29, 88	5.750%	2,000,000	1.10%	BAA1/BBB+
28 Western Mass. Electric	May 2, 88	6.375%	2,000,000	1.10%	BAA1
29 Western Mass. Electric	May 2, 88	6.375%	500,000	0.28%	BAA1
30 Aero Spatiale A	May 3, 88	5.450%	1,000,000	0.55%	AAA/AAA
31 AFS	May 3, 88	5.850%	2,000,000	1.10%	AAA/AAA
32 First Nationwide Cap. I	May 4, 88	5.680%	1,000,000	0.55%	AAA
33 CSX Corp	May 4, 88	5.220%	1,000,000	0.55%	A3/A-
34 Union Bancorp (APS)	May 6, 88	5.990%	1,000,000	0.55%	A1/BBB
35 Konica	May 9, 88	5.500%	2,000,000	1.10%	AAA/AAA
36 USAT II	May 10, 88	7.000%	2,000,000	1.10%	AAA/AAA
37 Com Fed Funding	May 10, 88	5.690%	2,000,000	1.10%	AAA/AAA
38 Ultramar A	May 11, 88	5.490%	1,000,000	0.55%	AAA
39 Chrysler	May 11, 88	5.800%	2,000,000	1.10%	BBB/BBB
40 Goldome	May 11, 88	5.710%	2,000,000	1.10%	AAA/AAA

MICROSOFT CORPORATION
Domestic Investment Portfolio
As of March 31, 1988

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
41 FFM IV	May 11, 88	5.590%	3,000,000	1.65%	AAA/AAA
42 Arlington	May 11, 88	5.500%	1,000,000	0.55%	AAA/AAA
43 FFM Finance IV	May 11, 88	5.590%	1,000,000	0.55%	AAA/AAA
44 USAT II	May 11, 88	7.000%	1,000,000	0.55%	AAA/AAA
45 Pacificorp B	May 13, 88	5.850%	600,000	0.33%	BAA1/BBB
46 EOA Auto Fund B	May 16, 88	5.650%	1,000,000	0.55%	AAA/AAA
47 Olympic Finance	May 16, 88	5.750%	1,000,000	0.55%	AAA
48 Olympic Finance	May 17, 88	7.461%	500,000	0.28%	AAA
49 Talman F	May 17, 88	5.510%	2,000,000	1.10%	AAA/AAA
50 Arvin Industries	May 17, 88	5.790%	1,000,000	0.55%	BAA/BBB
51 ASB Captial	May 17, 88	5.550%	1,000,000	0.55%	AAA/AAA
52 Arvin Industries	May 17, 88	5.7900%	1,100,000	0.61%	BAA/BBB
53 Cleveland Electric	May 17, 88	7.7000%	1,000,000	0.55%	BAA2/BB+
54 Chrysler	May 18, 88	5.8500%	400,000	0.22%	BBB/BBB
55 Golden Tulip KLM	May 20, 88	5.950%	1,000,000	0.55%	AAA/AAA
			73,614,250	40.55%	
		Total Domestic Investments	$149,824,024	82.54%	

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MICROSOFT CORPORATION
International Investment Portfolio
As of March 31, 1988

Issuer	Maturity Date	Effective Rate	Principal	Percent Of Portfolio	Rating Moody/S&P
Cash	N/A	N/A	13,305,805	7.33%	N/A
Bank Bills & CD's	N/A	N/A	1,404,708	0.77%	N/A
Increasing Rate Notes					
1 Tiger International	Mar 15, 89	12.375%	2,000,000	1.10%	N/R
2 Charlie Holdings-Revlon C	May 1, 90	13.500%	1,000,000	0.55%	N/R
3 Charlie Holdings-Revlon D	May 1, 90	14.250%	1,000,000	0.55%	N/R
4 Hickory Furniture	May 1, 90	12.750%	1,996,250	1.10%	N/R
5 Sunshine Mining Co.	Jun 1, 90	13.500%	2,000,000	1.10%	N/R
6 Vanguard Cellular	May 1, 92	13.000%	3,000,000	1.65%	N/R
8 Faberge	Dec 15, 92	14.250%	1,990,000	1.10%	N/R
9 HCA Investments	Sep 1, 99	12.375%	2,000,000	1.10%	N/R
10 Beatrice Company	Oct 1, 02	12.125%	2,000,000	1.10%	N/R
			$16,986,250	9.36%	
Total International Investments			$31,696,763	17.46%	
Total Domestic & International Investments			$181,520,787	100.00%	

Foreign Exchange Hedging Program

During the third quarter, significant improvements have been made in the foreign exchange (FX) hedging program. To begin with, our timely access to critical data has been greatly enhanced by the implementation of PC Link in Ireland which enables us to receive next day, via email, the daily detail of all invoicing from MS-Ireland to the subs. Thus, within twenty-four hours we know and can act on the FX exposure of MS-Ireland. Moreover, these reports have been customized to our needs and made identical to the reports produced in Redmond. Additionally, we have developed reports for sensitivity analysis of the effect of currency movements on our FX exposures which greatly facilitates our decision making process in placing FX orders.

Additionally, during the third quarter we have initiated a strategic change in the FX program by utilizing both forward contracts and sliding collar stop loss orders which become forward contracts when triggered. Consequently, we have greatly reduced our use of FX loans which avoids both debt on our balance sheet and dilution of our balance sheet ratios. Nonetheless, we shall continue to use FX loans to fund MS-Ireland working capital needs and to hedge when the forward points would generate a loss by using a forward contract. Other favorable characteristics of forwards include easier bookkeeping and significantly less utilization of FX credit lines. On the other hand, proceeds are realized in arrears rather than upfront. By using sliding scale stop loss collars, we are able to lock in specific stop loss price points during adverse currency movements, yet participate in FX gains during favorable currency movements.

The following table summarizes the status of our hedging program as of March 31:

FX HEDGING SUMMARY
(Dollars in Millions)

Exposure Type	Potential Exposure	Amount Hedged	Percent Hedged
Interco Receivables	$29.3	$23.4	79.7
Interco Loans	4.7	4.7	100.0
Interco Dividends	0.7	0.7	100.0
	$34.7	$28.8	82.9

Finally, Microsoft has booked $660,000 in FX gains during the third quarter and $2.5 million in gains for the year-to-date.

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Accounts Receivable

Accounts receivable (net) of $86.2 million increased 4%, ($3.3 million) from $82.9 million at the end of Q88-2. This growth can be attributed directly to the 3.8% rise in quarterly sales. Days sales outstanding, (shown below) for the past five quarters, increased only slightly from 48.1 days at the end of Q88-2 to 48.6 at the end of Q88-3.

FY Quarter	DSO
Q88-3	48.6
Q88-2	48.1
Q88-1	46.8
Q87-4	48.5
Q87-3	51.5

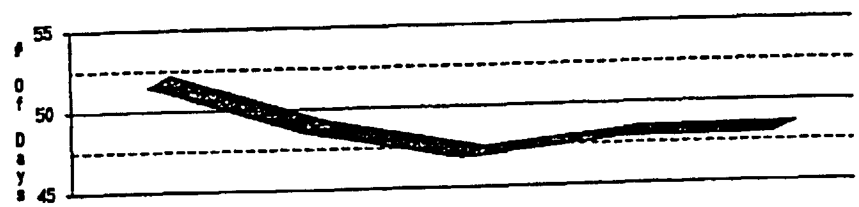
An analysis of the aging of the receivables shows that accounts over 60 days overdue comprised 15.1% of collectible receivables compared with 12.2% at the end of Q88-2. International Retail accounts for 45.8% of total collectible receivables and 52.3% of total collectible receivables over 60 days overdue. The $11.4 million allowance for doubtful accounts represents 86.6% of all accounts over 60 days compared with 96.4% at the end of the preceding quarter. In comparing the allowance for doubtful accounts against total collectible receivables, our reservation percentage is 13.1% compared to 11.8% at the end of Q88-2.

			Days Overdue		
	Total	Current	30-60	61-90	Over 91
Retail					
USSMD	$24,056	$14,089	$ 8,508	$1,077	$ 382
International	40,096	23,361	9,826	2,415	4,494
Worldwide Retail	64,152	37,450	18,334	3,492	4,876
OEM					
Domestic	5,077	3,235	1,137	319	386
International	15,482	9,155	3,064	1,486	1,777
Worldwide OEM	20,559	12,390	4,201	1,805	2,163
Press	2,416	1,507	24	36	849
CD-ROM/Systems Journal/PSS	288	242	50	(11)	7
Accounts Receivables-Collectible	87,415	$51,589	$22,609	$5,322	$7,895
Aging in percents		59.0%	25.9%	6.1%	9.0%
OEM GAAP adjustment	10,225				
Allowance	(11,445)				
Accounts Receivables-Net	$86,195				
Current Quarter Net Revenues	$161,823				
Days Sales Outstanding	48.6				

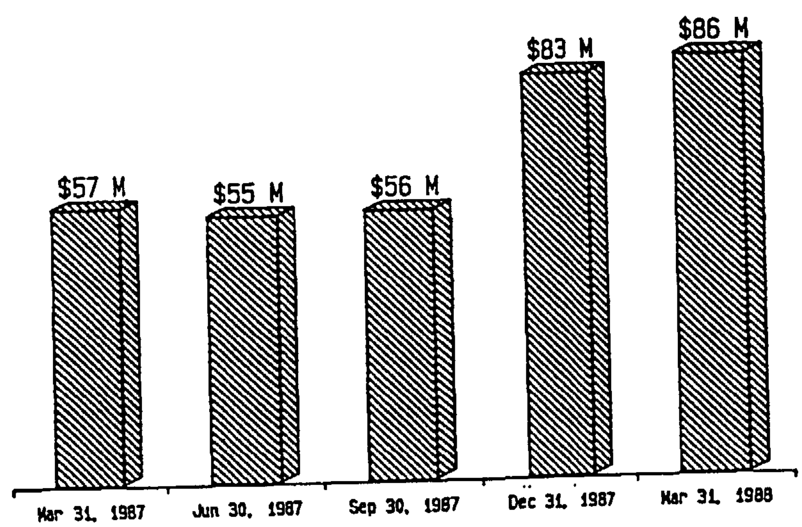
NOTE: Days sales outstanding calculation uses "Accounts Receivable - Collectible" and is based on current quarter net revenues.

Days' Sales Outstanding

(Based on Revenues for the Quarter)



Accounts Receivable - Net



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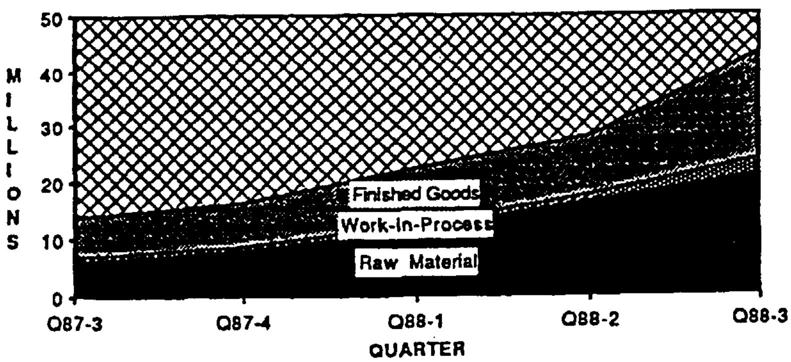
Inventories

At the end of Q88-3, total inventories were $43.0 million. This represents a 50.0% increase from the $28.6 million balance at the end of Q88-2. This change consisted of a $10.8 million increase in domestic inventories and a $3.5 million increase in international inventories. Domestic inventory increases were caused by growth in raw materials of $4.7 million (36.1%), work-in-process of $1.4 million (88.1%), and finished goods of $4.5 million (120.6%). These increases were in response to high sales volume and an effort towards "building to stock" as opposed to "building to order". The increase in international inventories was due entirely to a build up of finished goods. While both international raw materials and work-in-process decreased slightly, the level of finished goods increased by $3.8 million or 45.7%. The increase in finished goods inventory levels is a direct response to the "stock out" situation experienced in December 1987 and January 1988. The greater capacity of the Canyon Park facility will enable sufficient quantities of product to be built and stored to promptly meet required demand.

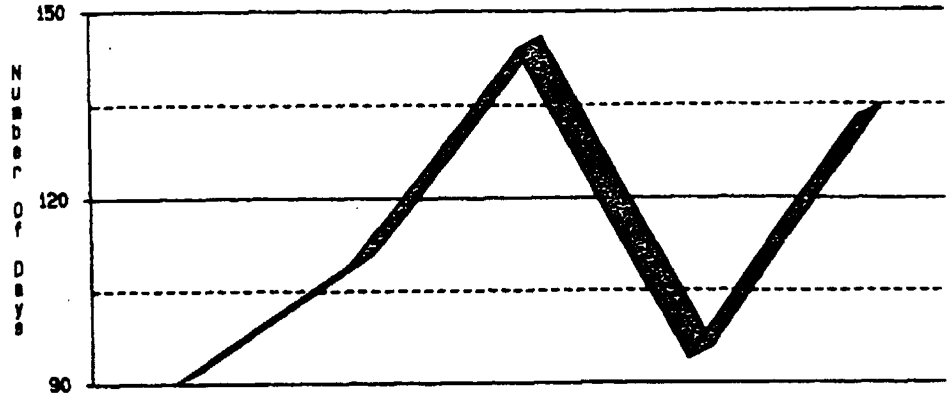
The inventory allowances remained relatively constant at $4.3 million at the end of Q88-3 compared to $4.4 million at the end of Q88-2. Thorough reviews of domestic inventories indicated that the domestic allowances did not need to increase in proportion to inventory levels. These reviews, in conjunction with the move to the Canyon Park facility, resulted in identification and disposal of significant quantities of obsolete material. Inventories ending Q88-3 and Q88-2 were as follows (in thousands):

	March 31	December 31	Change
Domestic Inventory:			
Raw materials	$17,724	$13,018	$ 4,706
Work-in-process	2,953	1,570	1,383
Finished goods	8,227	3,729	4,498
Allowances	(2,819)	(3,035)	216
Domestic subtotal	26,085	15,282	10,803
International Inventory:			
Raw materials	5,999	6,150	(151)
Work-in-process	33	182	(149)
Finished goods	12,269	8,422	3,847
Allowances	(1,432)	(1,394)	(38)
International subtotal	16,869	13,360	3,509
Consolidated Inventory:			
Raw materials	23,723	19,168	4,555
Work-in-process	2,986	1,752	1,234
Finished goods	20,496	12,151	8,345
Allowances	(4,251)	(4,429)	178
Consolidated inventory	$42,954	$28,642	$14,312

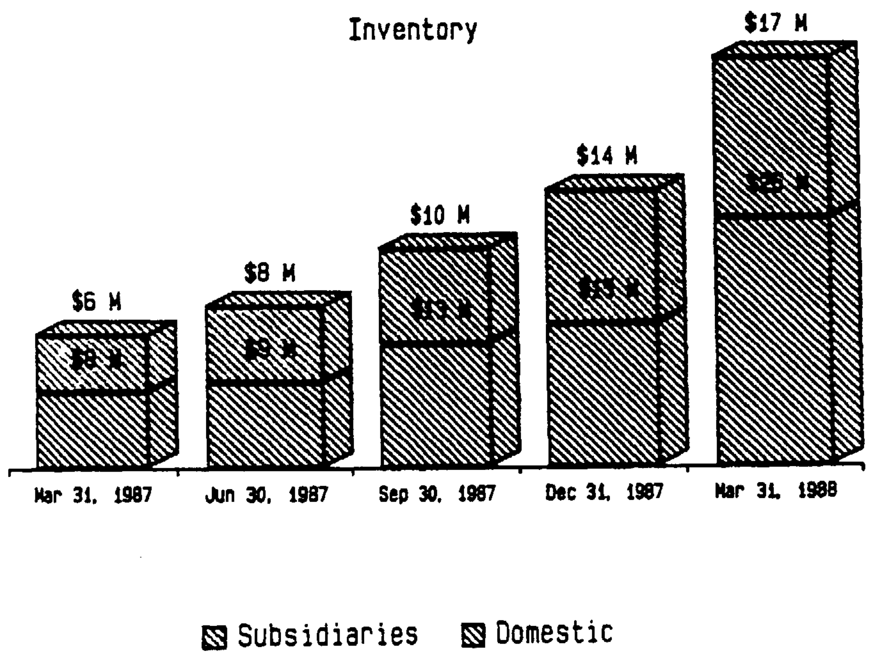


Days' Supply in Ending Inventory

(Based on Three Month Average Product Costs)



Inventory



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Property, Plant and Equipment

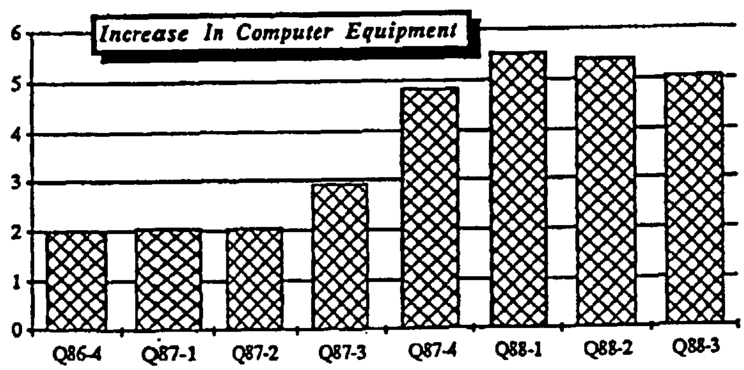
Net property and equipment increased 14.9% in Q88-3 to $100.2 million from $87.3 million at December 31, 1987. Again the increase can be primarily attributed to computer equipment and the expansion of our facilities to accommodate growth in headcount and manufacturing requirements. Property, plant and equipment at March 31, 1988 and December 31, 1987 consisted of the the following (in thousands):

	March 31	December 31	Change
Land	$32,038	$32,049	$ (11)
Buildings	26,648	20,118	6,530
Leasehold improvements	5,216	4,620	596
Furniture and equipment	17,215	13,331	3,884
Computer equipment	46,566	41,515	5,051
	127,683	111,633	16,050
Accumulated Depreciation	(27,457)	(24,373)	(3,084)
Net	$100,226	$ 87,260	$12,966

The significant increase in buildings ($6.5 million) is due primarily to construction in progress on the manufacturing and distribution facility in Canyon Park ($4.9 million) and the Ireland facility ($0.5 million). The increase in office furniture and equipment ($3.9 million) is largely the result of equipment for the manufacturing and distribution facility ($3.0 million) as the following schedule indicates (in thousands):

Manufacturing & distribution equipment	$3,047
Subsidiaries	393
Telecommunications equipment	342
Trade show booths	56
Furniture	46
	$3,884

As indicated in the following chart, computer equipment has increased approximately $5.0 million in each of the last four quarters.



The following table summarizes some of the more significant additions during Q88-3 (total costs are in thousands):

	Quantity Purchased	Total Costs
Compaq 386	252	$2,007
Subsidiaries	-	691
Apple Computers	166	689
Disk drives & memory expansion	-	374
VAX equipment	-	320
Wyse 286	90	264
IBM System 2	23	199
Networking equipment	-	131
Other miscellaneous items	-	376
		$5,051

Intellectual Property Rights

Intellectual Property Rights decreased $1.2 million in Q88-3 to $9.2 million from $10.4 million at December 31, 1987. The decrease results primarily from amortization of intellectual property rights acquired from Forethought.

Current Liabilities

Current liabilities decreased $13.3 million during Q88-3 to $93.3 million from $106.6 million at December 31, 1987. The decrease was the net result of significant changes in four areas. Due to a shift in strategy for minimizing exposure to foreign currency fluctuations, foreign currency notes payable were reduced by $21.8 million (see detailed discussion under "hedging"). That decrease was partially offset by an increase in accounts payable of $5.9 million reflecting an increase in inventories and equipment at Canyon Park. Customer deposits increased $2.0 million during the quarter as a result of a net increase in deferred revenue related to OEM billings prior to customer acceptance. Accrued payroll and payroll taxes increased $2.0 million due to the accrual of performance and NQSO bonuses.

Long-Term Liabilities

Long-term liabilities decreased by an insignificant amount ($141,000) to $4.2 million from $4.3 million at December 31, 1987 due to payments on long-term notes and leases.

Stockholders' Equity

Stockholders' equity increased $42.3 million during Q88-3 to $343.2 million from $300.9 million at December 31, 1987. The increase results primarily from net income for the quarter of $37.3 million and an adjustment to equity of $6.7 million to reflect the estimated tax benefit to Microsoft will receive from the NQSO conversion program.

BUDGET TARGETS
FISCAL YEAR 1989

MICROSOFT CORPORATION
BUDGET TARGETS
FISCAL YEAR 1989 PLAN

	FY 89 TARGETS		FY 88 PROJECTION		GROWTH PERCENT
NET REVENUES	820,000	100.0%	580,000	100.0%	41.4%
COST OF GOODS SOLD	224,500	27.4%	142,500	24.6%	57.5%
RESEARCH and DEVELOPMENT	90,000	11.0%	66,000	11.4%	36.4%
SALES and MARKETING 341,500	221,500	27.0%	150,000	25.9%	47.7%
GENERAL and ADMINISTRATION	30,000	3.7%	22,500	3.9%	33.3%
TOTAL COST AND EXPENSES	566,000	69.0%	381,000	65.7%	48.6%
INCOME FROM OPERATIONS	254,000	31.0%	199,000	34.3%	27.6%
NON-OPERATING INCOME	17,000	2.1%	11,000	1.9%	54.5%
STOCK OPTION BONUS (EXP)	-8,000	-1.0%	-15,000	-2.6%	-46.7%
INCOME BEFORE INCOME TAXES	263,000	32.1%	195,000	33.6%	34.9%
PROVISION FOR INCOME TAXES	87,000	10.6%	64,000	11.0%	35.9%
NET INCOME	176,000	21.5%	131,000	22.6%	34.4%
AVERAGE SHARES OUTSTANDING	56,500		55,800		1.3%
EARNINGS PER SHARE	$3.12		$2.35		32.7%

MICROSOFT CORPORATION
QUARTERLY GROSS REVENUE FORECAST
FISCAL YEAR 1989

CHANNELS	FY 89 PRELIMINARY						FY 88 PROJECTED	
	Q1 89	Q2 89	Q3 89	Q4 89	TOTAL	INDEX	TOTAL	INDEX
USSMD	60,681	71,521	79,766	83,670	295,638	35.3%	200,000	33.7%
INTERNATIONAL RETAIL	51,475	75,849	81,182	88,118	296,625	35.4%	197,000	32.1%
OEM	20,264	23,084	30,236	28,849	102,432	12.2%	79,000	13.8%
PACKAGED PRODUCTS	3,419	5,154	5,329	5,620	19,523	2.3%	25,000	4.8%
INTERNATIONAL OEM	22,941	21,700	25,838	28,370	98,849	11.8%	74,000	12.8%
PRESS	3,674	3,896	4,287	2,398	14,255	1.7%	9,500	1.6%
MICROSOFT UNIVERISTY	796	1,069	1,385	1,840	5,090	0.6%	0	0.0%
PRODUCT SUPPORT	329	301	518	560	1,708	0.2%	5,000	0.9%
MICROSOFT JOURNAL	225	450	650	520	1,845	0.2%	2,000	0.3%
CD ROM	63	126	144	254	587	0.1%	500	0.1%
CD CONSUMER	74	155	155	77	461	0.1%	0	0.0%
TOTAL CHANNELS	163,940	203,305	229,490	240,277	837,013	100.0%	592,000	100.0%

COMMODITIES	FY 89 PRELIMINARY						FY 88 PROJECTED	
	Q1 89	Q2 89	Q3 89	Q4 89	TOTAL	INDEX	TOTAL	INDEX
APPLICATIONS	62,557	81,670	99,973	107,326	351,526	42.0%	238,000	39.7%
SYSTEMS	52,810	58,067	68,768	66,623	246,268	29.4%	187,000	31.3%
LANGUAGES	14,756	19,749	23,871	20,412	78,787	9.4%	60,000	10.3%
HARDWARE	23,062	33,033	24,445	29,023	109,562	13.1%	64,000	10.8%
BOOKS	4,017	4,421	4,746	2,819	16,001	1.9%	11,000	1.8%
XENIX	1,347	1,383	1,774	1,360	5,864	0.7%	9,000	1.5%
NETWORKING	728	1,019	2,034	2,834	6,616	0.8%	2,000	0.4%
PRODUCT SUPPORT	1,341	1,790	2,357	2,798	8,286	1.0%	0	0.0%
CD ROM	243	478	701	739	2,160	0.3%	2,000	0.4%
MICROSOFT JOURNAL	225	450	650	520	1,845	0.2%	2,000	0.3%
CD CONSUMER	148	347	465	387	1,346	0.2%	0	0.0%
NON-SPECIFIC	2,707	899	-292	5,437	8,751	1.0%	17,000	3.5%
TOTAL COMMODITIES	163,940	203,305	229,490	240,277	837,013	100.0%	592,000	100.0%
FY 89 PLAN %'S	19.6%	24.3%	27.4%	28.7%	100.0%			
FY 88 ACTUALS (Q4 EST)	104,000	158,000	165,000	165,000	592,000			
FY 88 PROJECTED %'S	17.6%	26.7%	27.9%	27.9%	100.0%			

ADMINISTRATION

TAX MATTERS

TAX MATTERS

DOMESTIC PLANNING

"Spread" from Stock Plans/Alternative Minimum Tax Through the third quarter, the spread on the stock options exercised year to date equaled $23,880,068. This compares to $19,443,542 through the third quarter of FY 87. We will continue to monitor this closely during the final quarter as it could subject Microsoft to an Alternative Minimum Tax (AMT). However, as of today we do not feel Microsoft will incur an AMT liability for FY88.

Accumulated Earnings/Anticipated Liquidity Needs As of March 31, 1988, Microsoft's estimated working capital at the end of the fiscal year and forecasted liquidity needs are summarized in the table below:

Estimated working capital at June 30, 1988	$ 259,676
Estimated working capital needs (based upon Bardahl formula)	201,343
Estimated working capital before other anticipated needs and contingencies	58,333
Other anticipated needs and contingencies	276,750
Potential borrowing requirements	$(218,417)

A detailed analysis follows this report.

DOMESTIC COMPLIANCE

IRS Exams The IRS is presently examining Microsoft's tax years ended in 86 and 87. Two "large case" agents, domestic and international, have been assigned to the exam. We anticipate they will be in our offices for at least the next few months. After their field work has been completed, the length of time needed to close the exams will be determined by the issues raised and the approach chosen to settle these issues.

The potential magnitude of an IRS exam was recently illustrated by the assessment against Apple. In its exam for 81 through 83, the Service claimed that Apple owes $75 million in additional taxes. Apple has contested the assessment in U.S. Tax Court. A copy of an article from the San Jose Mercury News discussing the Apple exam has been included at the end of the Tax Matters section.

State Exams Microsoft is currently undergoing income and sales/use tax exams in the states of California and Massachusetts.

Tax Returns Microsoft has filed all federal, state and FSC returns on a timely basis for FY 87. These returns were prepared entirely in-house using a micro-based Tax Management System software. The following information is based on the final tax returns filed with the tax authorities:

	Amount ($000)	Effective Tax Rate
Pretax book income (MS-Corp only)	$93,116	
U.S. Income Tax	$11,415	12.3%
Total State Income Taxes	$1,264	1.4%

These low effective tax rates are primarily due to the "spread", the R&D credit and foreign tax credits.

INTERNATIONAL PLANNING

Cost Sharing with MS-IRE Research and discussions have been initiated regarding the adoption of a cost sharing agreement between MS-Corp and MS-Ire. The cost sharing agreement would result in the allocation of product development costs between MS-Corp and MS-Ire. The implementation of a bona fide cost sharing agreement provides a permissible alternative to the "super royalty" provisions enacted by the 86 Tax Act.

The "super royalty" provisions require royalty payments with respect to intangibles transferred to a foreign related party be commensurate with the income attributable to the intangible. These rules could impact the license between MS-Corp and MS-Ire for the manufacture and distribution of software products. The IRS could potentially argue based on the "super royalty" provisions that MS-Ire should pay a larger royalty to MS-Corp despite the establishment of the 22% royalty in accordance with an "arms-length" standard.

Foreign Tax Credit Limitation The Tax Department recently completed a computation of the foreign tax credit (FTC) limitation as of February 29, 1988 under the new rules effective for this fiscal year. The computation confirmed our belief that Microsoft will not be limited under the new method in its ability to utilize foreign tax credits for FY 88. This determination is critical to the potential repatriation of profits from our foreign subsidiaries.

New Foreign Subsidiaries The Tax Department is working with other support and operational departments in the formation of subsidiaries in India, Egypt and Mexico. Also we are assisting in the analysis of acquiring our exclusive Korean sales agent, MSSA. At present, Microsoft has no financial interest in MSSA.

Thin Capitalization The issue of thin capitalization has been raised with respect to a few of our foreign subsidiaries. In the U.K., Inland Revenue has assessed a tax deficiency equal to approximately 20,000 pounds against MS-Ltd due to under capitalization. In MS-Gmbh and MS-KK we have discussed increasing capital. New Australian tax laws will force us to address this issue in MS-Pty in the near future as well.

INTERNATIONAL COMPLIANCE

Exams of Foreign Subsidiaries The first significant tax examinations by the respective tax authorities are currently underway at MS-Gmbh, MS-KK, MS-Ltd and MS-Sarl. We are monitoring the developments in these exams closely with the controllers of these subsidiaries.

MICROSOFT CORPORATON
Anticipated Liquidity Needs
Year Ending June 30, 1988
(in thousands)

Working Capital Available

Working Capital at March 31,1988	$229,176
Add: Anticipated working capital to be generated through June 30,1988	30,500
Estimated Working Capital at June 30, 1988	259,676
Less: Estimated working capital to sustain the Company through fiscal 1988	201,343
Total Before Other Anticipated Needs	$58,333

Anticipated Needs

Scheduled Expenditures	
Facilities:	
Computers	$21,900
PSS CMS	4,500
Phase III Development	73,000
Canyon Park (new facility and current)	5,000
Land	10,000
Foreign Operations:	
Irish facility/new addition	7,500
Foreign Subs. -New Locations	1,750
Capital contributions (GMBH, KK, LTD, PTY)	3,000
Foreign subsidiaries -Improvements	1,500
Acquisitions	100,000
Dividends	?
	228,150
Contingencies	
Insurance	20,000
Foreign Operations:	
Value Added Taxes	5,000
Other International Taxes	5,100
Litigation and contingencies:	
Litigation (Personnel)	13,500
Litigation (Apple)	?
State Taxes	5,000
	48,600
Total Anticipated Needs	276,750
Potential Borrowing Requirement	**-$218,417**

MICROSOFT CORPORATION
Estimated Working Capital Needs Worldwide: Peak Method
Year Ending June 30, 1988
(in thousands)

Step 1. Determine Operating Cycle		
A. Inventory turnover percentage		
1) Peak inventory (3/88)	$42,955	
2) COGS for the period	139,100	
3) Inventory turnover percentage		30.88%
B. Accounts receivable turnover percentage		
1) Peak accounts receivable (3/88)	97,640	
2) Sales for the year ending 6-30-88	570,000	
3) Accounts receivable turnover percentage		17.13%
C. Operating cycle percentage		48.01%
Step 2. Determine Working Capital		
1) COGS	139,100	
2) Other operating expenses (as budgeted)	240,030	
3) Income taxes-worldwide basis *	52,248	
	431,378	
4) Less: depreciation	-12,000	
5) Estimate of FY88 total operating expenses	419,378	
Necessary Working Capital (48.01% x $419,378)		$201,343

Notes:
*

570,000	FY88 estimated rev's
379,130	COGS + operating expenses
190,870	Pretax profit
48,000	FY88 NQSO deduction
10,800	Other Income
153,670	
34%	Tax rate
52,248	Total worldwide tax liability

IRS audit of Apple worries Silicon Valley companies

By Evelyn Richards
Mercury News Technology Editor

The whopping tax bill the Internal Revenue Service slapped on Apple Computer Inc. late last year includes a controversial interpretation of employee compensation that, if upheld, could cost Silicon Valley companies millions of dollars.

At issue are stock options that are used by fast-growing companies to lure engineers and other professionals with the chance to make money if a firm's stock rises. Specifically, the IRS challenged tax credits claimed by Apple after employees received shares of stock by exercising "non-qualified stock options."

Disputes over these options account for about $8 million of the approximately $75 million that the IRS claimed Apple owed in back taxes for 1981 through 1983. The IRS delivered its bill in August after the Cupertino computer maker refused to allow auditors to continue examining its books for those years.

The IRS has stepped up its auditing force in Silicon Valley, and the Apple assessment is seen as an omen of possible tax disputes for other local companies.

Apple, which paid the bill but expects a refund, has protested the IRS findings in U.S. Tax Court in Washington, refuting one by one the more than 30 points raised by the government. The two sides are likely to resolve most of the issues without litigation in tax court.

The IRS challenges fall into two categories. Most center on expense deductions claimed by Apple, but the agency also has challenged tax credits the company claimed. Deductions reduce income, whereas credits reduce taxes directly.

The result, according to the IRS, is that Apple had taxable income of more than $275 million from 1981 through 1983 — not the $154 million the company reported. And the IRS says Apple owed taxes of approximately $125 million for those years. It had paid about $50 million.

Perhaps the stickiest issue for Apple — and many other Silicon Valley companies — is the IRS interpretation of rules for the research and development tax credit.

Under a 7-year-old law, companies may claim a tax credit that represents a portion of their increased spending on research and development. The IRS has never issued detailed regulations for the credit, however, so companies cannot be sure that the credits they claim will be honored by the government.

"It's an issue for everybody until they clearly resolve what constitutes wages for R&D tax credits," says Larry Langdon, tax director for Palo Alto-based Hewlett-Packard Co. and president-elect of a nationwide organization of tax executives.

> 'It's an issue . . . until they clearly resolve what constitutes wages.'
> — *Larry Langdon, tax director for Hewlett-Packard Co.*

One dispute over research and development involves how to categorize the gain an employee realizes when he or she exercises a non-qualified stock option. When an employee exercises a non-qualified option — which means he or she obtains the shares of stock — the difference between the exercise price of the option and the market value of the stock is considered ordinary income to the employee. It is also an expense for the corporation.

Because it is treated as compensation, many Silicon Valley companies, including Apple, H-P, Amdahl Corp. and Intel Corp., decided that the difference between the exercise price and the market value can count as spending on research and development. And the more the spending on research and development, the larger the tax credit. But the IRS disputed that position in the Apple audit.

Until it is resolved by the IRS, the issue is likely to be raised in the audits of several Silicon Valley companies. "Sooner or later we're all going to have it," says Robert Perlman, tax director of Intel in Santa Clara.

Losing their argument could have a "fairly significant impact" on local companies, says Tom Meredith, assistant treasurer at Sunnyvale-based Amdahl. "It will reduce the amount of their R&D tax credit (and) could have a significant profit-and-loss impact."

In addition to the research and development tax credit, many of the points raised by the IRS in the Apple audit involve international tax issues. Documents filed with the court reveal that, among other things, the IRS believes that:

- Apple's former Domestic International Sales Corp., a "paper" company designed to promote exports by giving tax incentives, did not qualify for tax breaks.
- Apple did not transfer goods and services at proper prices between the parent company and subsidiaries in Singapore and Ireland. For example, the IRS claims Apple paid too much for printed circuit boards it bought from its Singapore subsidiary. If it had paid a more realistic price, the IRS claims, Apple's income would have increased in 1983 by $25 million.
- Apple accounted for an $11 million payment in 1981 from its Irish operations as repayment of a loan. Instead, the IRS says, the money represented taxable income to Apple.

INSURANCE MATTERS

INSURANCE MATTERS

All coverages continue in full force and effect including coverage on the new M&D facility. The Corporation does not carry any earthquake insurance; however, given the tilt-up construction and vast roof expanse of the M&D building, we are in the process of obtaining a quote for earthquake coverage for this facility.

On another matter, it appears that the D&O market is softening, and we are aware of three inquiries from carriers expressing interest in providing Microsoft with D&O coverage. Thus, below is a brief outline of three possibilities with only very approximate numbers. Assuming there will be interest in pursuing outside coverage, we shall obtain firm quotes:

1. NATIONAL UNION

   $20 to $25 million coverage

   $250,000 deductible for Corporate portion of coverage

   $275,000 to $325,000 approximate premium

   It appears that National is offering a "clean" D&O policy with better terms and conditions than in the recent past and with no critical exclusions. This policy would provide coverage for all D&O's and for Microsoft.

2. AETNA - Liability coverage for independent directors only

   Up to $10 million coverage for outside directors only

   Deductibles and premiums not known for this new coverage, but anticipation is that it could be quite reasonable - possibly in the five figure range.

   This coverage is intended to supplement existing coverage such as any "differences in conditions" (DIC) that might exist with our trust arrangement. However, it also can be purchased as primary coverage where Microsoft or the trust could not indemnify. Furthermore, it is non-cancellable.

3. CODA - "Corporate Officers & Directors Assurance" - Bermuda

   This captive insurer has built a relatively formidable equity base and is thought to be looking for business. CODA does not lay off any of their coverages to re-insurers.

   CODA may offer $25 million coverage for $150,000 per year, but the insured must "buy in" upfront with a three-year premium and a prepayment of $450,000. However, CODA issues a three-year non-cancellable policy and the upfront money is applied pro-rata against future years' premiums.

   CODA only provides coverage where other indemnification cannot be obtained, whether or not the insured has other insurance. Again, this coverage might supplement our trust concept well, and the protection covers all D&O's.

Finally, in light of the large premiums the Company pays to Washington State for workers' compensation, we are exploring the feasibility of self-insuring this exposure.

FACILITIES EXPANSION REPORT

FACILITES EXPANSION

In the United States, Microsoft now occupies or is developing approximately 1.3 million sq. ft. which is up from the approximately 25,000 sq. ft. in 1981. The following information provides an update on the major components of this space. Appended is a map of the Corporate Campus area for reference.

New Manufacturing and Distribution Facility

This new 260,000 sq. ft. facility at Canyon Park Business Center (Campus North) was completed on time and within budget.

The move began on March 18 with portions of raw materials and finished product being moved first. The production lines were moved on March 24 and back in operation the next afternoon. The balance of finished goods and raw materials along with office personnel occurred on April 7 - 9.

As evidence that this move occurred as seamlessly as possible, approximately $5.7 million of product was shipped in its first week of operation.

The best understanding of Campus North is gained by visiting it.

Phase III

Buildings 8 and 9 are well underway. Building 8, which began on February 22, 1988, is making very good progress under the new construction process (cast in place). The steel is in place and concrete floors are being poured in sequence. Building 9 construction began March 28 and foundations were started April 20, 1988. Both buildings 8 and 9 are on schedule with occupancy planned for November 15 and January 15 respectively.

Upon further review of our central computer room requirements it was concluded that a separate dedicated computer building would best suite those needs as well as free up primary office space in the development buildings. Accordingly, planning is underway for building 11 to be located on the southwest side of building 10 (see map). Completion of this approximately 50,000 sq. ft. building is targeted for March 1989 or sooner if possible.

Phase IV Land Purchase

As our growth continues our space needs require additional land. In order to protect our investment at this site and permit contiguous growth, the purchase of the remaining 20 acres of undeveloped land at Evergreen Place was recommended. This will permit an additional 300,000 sq. ft. of office building along current designs with maximum parking. It will also permit the construction of building 10 without regard to the completion of 156th Street L.I.D. because building rights can be transferred from Phase IV.

The estimated cost of this new land is $9,000,000 which is about $17.61 per buildable sq. ft. or about $4 less per buildable sq. ft. than the cost of the Phase III land.

In addition, there are certain obligations that will be assumed. These include approximately $465,000 for common space development and standard LID costs. The purchase and sale agreement is being reviewed and the closing is scheduled for May 20. Two other parties had also made offers for this land. See the following map which shows this new land.

East Tech Moves

Starting on April 15 and for the two following weekends, the moves of several groups to the East Tech buildings began. These buildings, located one block north of the entrance to the Corporate Campus, include about 60,000 sq. ft. which will provide short term occupancy for CD Rom, Press, and Hardware until building 9 is completed. Additionally, other functions that are moving during this period and will stay longer term include the mail/copy room, training rooms, and OEM manufacturing.

The Administration group is keeping the pulse on available office space in the immediate area to provide short term space until buildings 8 and 9 are completed.

MSU

Microsoft university was expanded at the old Northup Building to approximately 18,000 sq.ft. from 9,000 sq.ft. This expansion included additional training and support areas, as well as office for all MSU personnel from the Corporate Campus. This move from Corporate Campus also occurred during the quarter.

German Office and Warehouse

German (GmbH) Office and Warehouse Lease

Rental Space	Square Meters
Office Building	3,428
Warehouse	1,644
Total	5,072
Costs	**(Deutschemark - 000's)**
Site	3,550 DM
Construction	9,569
Professional fees, permits, etc.	2,025
Total	15,144 DM

Lease Terms:

10 year, 3 year no increase, modest inflation clause in 3 year intervals.
Rent approximately 1,067,00 DM annually. This is 7% return on total costs.
Sublet allowable.

Budget Factors

In FY89, GmbH plan, including moving expenses:
- Estimated occupancy May, 1989
- Expansion - 60% for both office and warehouse
- Should be sufficient for 5 years at present projected growth rates.

Further detail under separate cover.

Field Offices

In addition to the Redmond area space occupied and under development, twelve field locations are developed and managed (space identification, leasing, space lay out, communication systems, etc.) by the Administration group. These include major offices in Boston, New York, Chicago, Dallas, Los Angeles, and the Silicon Valley area. See the chart for exact locations.

Irish Facilities Expansion

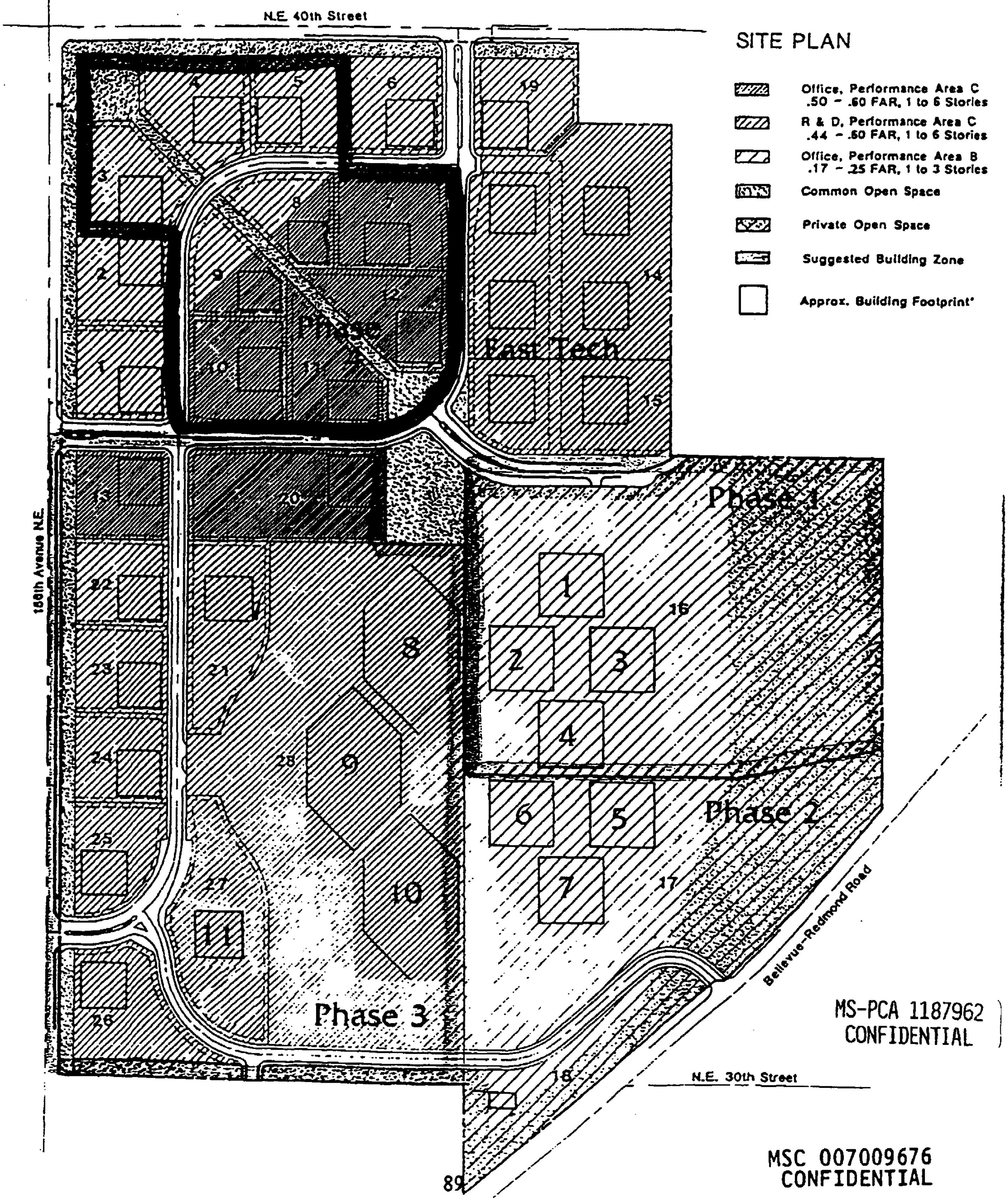
The project is continuing to proceed on schedule. Roofing and flooring are complete and the shell is nearing complete enclosure. Overall occupancy is still on target and scheduled for October 1988.

MICROSOFT SPACE - UNITED STATES

CURRENT DEVELOPMENT	EXACT SQ FT
Canyon Park Expansion	102,000
Corp Com	31,013
East Tech Bldg B	12,234
East Tech Bldg D	27,433
East Tech Bldg C	5,787
Ph 3 Bldg 8	117,500
Ph 3 Bldg 9	117,500
Ph 3 Bldg 10	117,500
Ph 3 Bldg 11	60,000
Sunnyvale	10,000
Boston	4,016
Los Angeles	11,822
Santa Clara	7,158
TOTAL	623,963

CURRENT MANAGED	
Canyon Park	264,136
Phase 1 (1 - 4)	240,000
Phase 2 (5 - 6)	120,000
MSU	18,248
New York	6,621
Boston	
Wash DC	4,899
Atlanta	1,492
Detroit	1,924
Chicago	4,846
Dallas	6,953
El Segundo	2,471
Mt View	3,072
Corp Com	21,400
Sunnyvale	6,250
NY Systems J	3,200
TOTAL	705,512

GRAND TOTAL 1,329,475



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STOCK/INVESTOR RELATIONS

STOCK/INVESTOR RELATIONS

Research Analysts Earnings

Revenue and earnings estimates of the primary sell-side research analyst that actively follow Microsoft are listed below. These estimates are dynamic, and based upon current GAPP reporting (including the stock option program expense.) While all the analysts are impressed with the third quarter results, the Apple lawsuit is a "black cloud" over the trading of MSFT. Only one analyst has written a negative report because of the lawsuit and this report is attached.

	Company/Analyst	FY88 E.P.S. Revenue	FY89 E.P.S. Revenue
1.	Alex Brown & Sons Chris Mortensen	$2.30 $575M	$3.30 $770M
2.	Cable, Howse & Ragen Teresa Lotsgezell	$2.30 $580M	$3.1 $770M
3.	Dain Bosworth Jay Tijera	$2.30 $560M	$2.75 $690M
4.	Dillon Reed John Maxwell	$2.29 $575M	N/A N/A
5.	First Boston Bruce Johnston	$2.30 $580M	$3.40 $820M
6.	Goldman Sachs Rick Sherlund	$2.35 $585M	$3.00 $760M
7.	Hambrecht & Quist David Thomas	$2.35 $575M	$3.70 $830M
8.	Kidder Peabody Bahar Gidwani	$2.28 $575M	$3.05 $710M
9.	C. J. Lawrence Mary McCaffrey	$2.35 $580M	$3.15 $750M
10.	Montgomery Securities Bill Shattuck	$2.36 $580M	$3.35 $800M
11.	Paine Webber Bob Therrian	$2.35 $570M	N/A N/A
12.	Piper Jaffray Tom Friedberg	$2.33 $570M	$3.00 $750M
13.	Smith Barney David Readerman	$2.37 $585M	$3.25 $740M
14.	Soloman Brothers Michele Preston	$2.35 $580M	$3.50 $760M
15.	Value Line Rob Martorana	$2.35 $600M	N/A N/A

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Rating Change

Technology Group

PaineWebber

3/18 price:	$58 1/4 OTC--MSFT		
52-week range:	$49 3/4-65 1/2		
FY: 6/30	1987	1988E	1989E
Q1	$0.29	$0.42A	$0.53
Q2	0.35	0.68A	0.75
Q3	0.39	0.54	0.63
Q4	0.36	0.60	0.78
Year	1.40	2.25	2.70
P/E	--	28.4	23.7
Div.	--	--	--
Yield		--	--
Secular Growth Rate			25%
Optionable			

Microsoft

Unattractive

Apple saga continues

We downgraded Microsoft* on March 18th to unattractive (4) from neutral (3) because, at minimum, Apple's* ($44 3/4) lawsuit against Microsoft reduces the probability that Microsoft can achieve its earnings targets. Although it is too early to predict the outcome of the lawsuit, because of the increased uncertainty we believe Microsoft's multiple of 24x $2.50 calendar 1988 earnings will come down. We will not cut our estimates until we get further clarification from Microsoft.

Details of lawsuit

Apple is suing Microsoft over Windows Version 2.03, a product that many observers (including us) believe makes the IBM ($114 1/4) PC look like a Macintosh. Apple claims that Windows exceeds "the limited license rights granted to Microsoft by Apple." The key word is limited. Microsoft did indeed sign a contract with Apple regarding Windows in 1985, when the Macintosh was not selling well. We do not know the exact wording of the document; however, we know that Apple was vitally interested in protecting its technology at that time.

We have talked to a number of software lawyers. Although intellectual property law in the software business is not yet defined, we believe that Microsoft's signing a contract with Apple puts Microsoft in a weaker position than if it had not signed anything. On the other hand, because we have not seen the Apple/Microsoft agreement, we do not know where the line was drawn, nor do we know (if there was a line) whether Microsoft crossed it.

Presentation Manager and Windows 386 affected

Apple wants the court to stop Microsoft from selling Windows 2.03 and "any derivative work based thereon." Both Presentation Manager and Windows 386 are derivative products. The lawsuit could set back Microsoft's efforts in both operating systems software and applications software by quite some time.

Why was everybody blindsided?

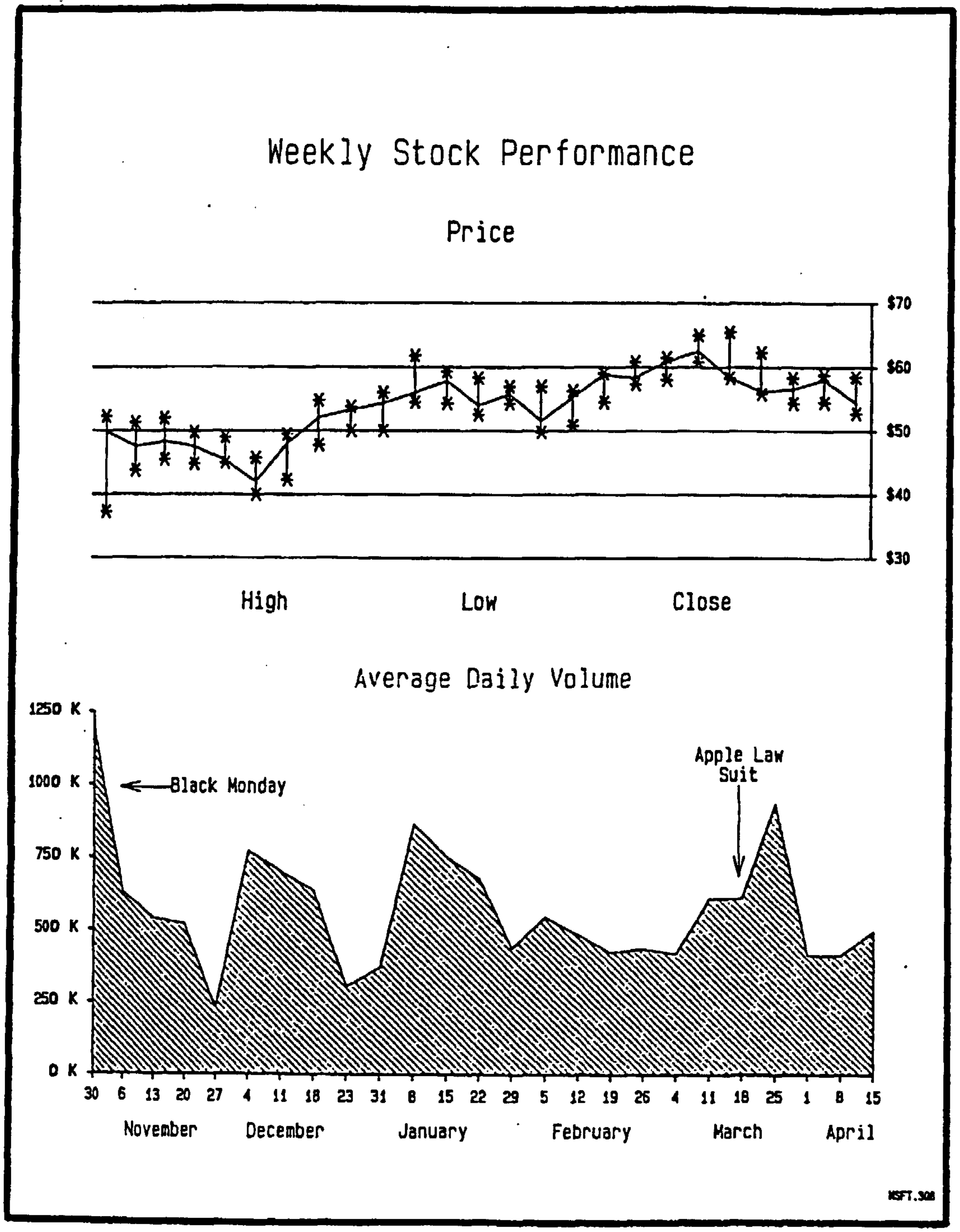
Microsoft has claimed that it has obtained rights to the entire scope of Windows 2.03 through its agreements with both Apple and Xerox ($57 1/4) (the original inventor of the graphical interface). Given that IBM has staked its reputation on the Presentation Manager interface, and a number of other hardware vendors have followed, we believed--as did everybody--that Apple would not sue Microsoft.

Possible earnings impact

While we believe that it is too early to cut our estimates, we will provide some guidelines for evaluating a possible loss of the lawsuit. Windows-related products would not be the only software affected by the lawsuit. Much of Microsoft's applications software business--spreadsheet, word processing, database and graphics--either uses or will use Windows in the final product. Therefore, if Microsoft were to lose the lawsuit, we estimate that reduced revenues for software written for the IBM PC would result in estimate cuts of $0.80-$1.00 per share. Furthermore, Microsoft has signed many agreements with third parties to license Windows and Presentation Manager. It is as yet unclear how these third parties will react.

March 21, 1988

Robert M. Therrien (212)713-4921



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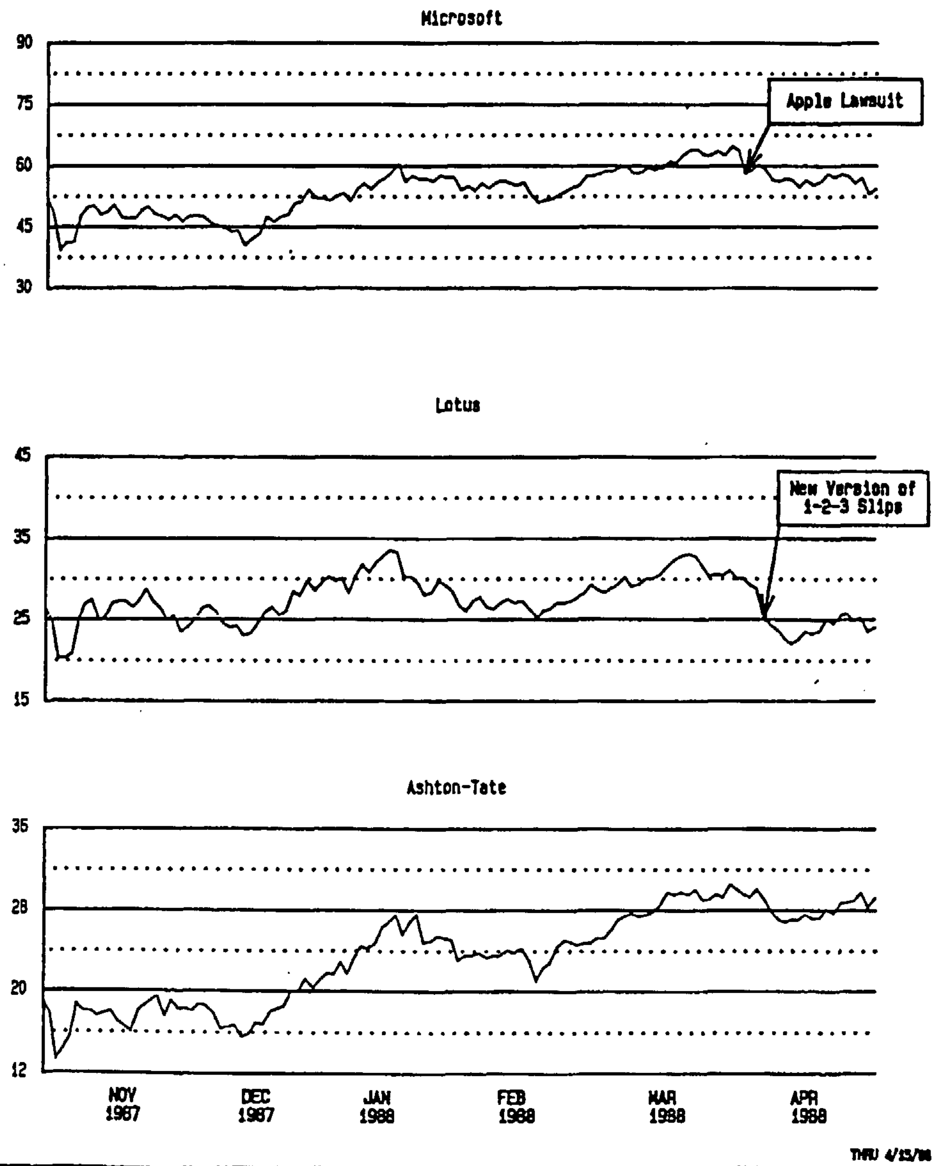
Microsoft, Lotus, and Ashton-Tate

Comparative Closing Prices



MICROSOFT CORPORATION
SUMMARY OF STOCK OPTION PLAN ACTIVITY
AS OF MARCH 31, 1988

Options Available For Grants

	Available Beginning Of Period	Additions: New Approvals	Additions: Forfeited Shares	Reductions: Net Shares Granted (1)	Available End Of Period
Fiscal 1982	0	9,440,000	0	(1,714,000)	7,726,000
Fiscal 1983	7,726,000	0	209,800	(1,858,800)	6,077,000
Fiscal 1984	6,077,000	0	830,702	(1,516,230)	5,391,472
Fiscal 1985	5,391,472	0	474,336	(1,313,430)	4,552,378
Fiscal 1986	4,552,378	1,400,000	415,489	(2,469,158)	3,898,709
Fiscal 1987	3,898,709	2,000,000	348,271	(2,411,700)	3,835,280
Fiscal 1988					
Q88-1	3,835,280	0	67,875	(942,950)	2,960,205
Q88-2	2,960,205	0	57,514	(1,399,200)	1,618,519
Q88-3	1,618,519	0	133,375	(221,400)	1,530,494
	TOTALS	12,840,000	2,537,362	(13,846,868)	

Outstanding Stock Options

	Outstanding Beginning Of Period	Additions: Net Shares Granted (1)	Reductions: Shares Exercised	Reductions: Forfeited Shares	Outstanding End Of Period
Fiscal 1982	0	1,714,000	0	0	1,714,000
Fiscal 1983	1,714,000	1,858,800	(3,800)	(209,800)	3,359,200
Fiscal 1984	3,359,200	1,516,230	(143,584)	(830,702)	3,901,144
Fiscal 1985	3,901,144	1,313,430	(429,806)	(474,336)	4,310,432
Fiscal 1986	4,310,432	2,469,158	(1,208,032)	(415,489)	5,156,069
Fiscal 1987	5,156,069	2,411,700	(1,682,832)	(348,271)	5,536,666
Fiscal 1988					
Q88-1	5,536,666	942,950	(148,963)	(67,875)	6,262,778
Q88-2	6,262,778	1,399,200	(102,223)	(57,514)	7,502,241
Q88-3	7,502,241	221,400	(350,980)	(133,375)	7,239,286
	TOTALS	13,846,868	(4,070,220)	(2,537,362)	

Footnotes:

(1) Net shares granted is equal to gross shares less ISOs converted to NQSOs.

* Historical numbers may change from quarter to quarter due to ISO conversions and the issuance of grants for prior periods.

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MICROSOFT CORPORATION
STOCK OPTIONS GRANTED
New Hires vs. Existing Employees by Department

	Existing Employees		New Hires		Total	
	# Shares	# Grants	# Shares	# Grants	# Shares	# Grants
FISCAL YEAR 1988						
Administration	1,000	1	25,000	2	26,000	3
Applications	10,000	1	26,000	5	36,000	6
CD ROM	0	0	1,500	1	1,500	1
International Subs	0	0	17,000	5	17,000	5
Language Software	0	0	38,300	5	38,300	5
Network	0	0	21,000	5	21,000	5
Systems	0	0	25,600	6	25,600	6
US Sales & Marketing	26,000	2	10,000	2	36,000	4
User Education	5,000	3	15,000	5	20,000	8
JAN 1 - MAR 31	42,000	7	179,400	36	221,400	43
TOTAL 1988	1,491,150	302	1,072,400	209	2,563,550	511

HUMAN RESOURCES

STATUS REPORT

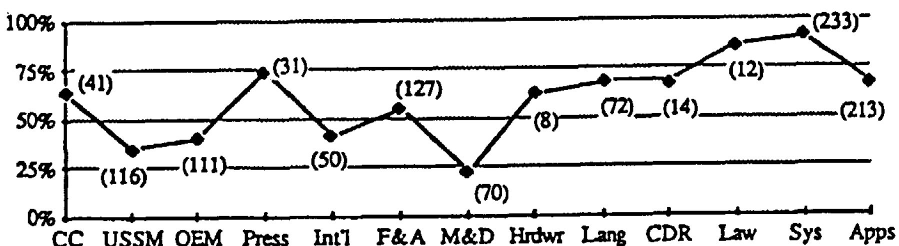
HUMAN RESOURCES

Savings Plus Plan

Employee participation in the Savings Plus Plan is averaging 66% of those eligible to participate. The average deferral contribution rate is 8%. Employees have been active in deciding how the funds have been invested among the four options available with Savings Plus (see Investment Option Participation trend chart on the following page). Most notable is the 11% shift of funds from the Common Stock Fund to the Income Fund. We anticipate this trend to continue throughout 1988.

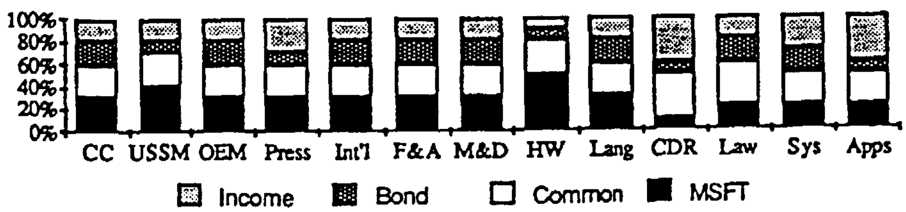
Savings Plus Plan
Average Deferral by Division
as of March 31, 1988

Savings Plus Plan
Participation by Division
as of March 31, 1988



( ) Number of Participants

Savings Plus Plan
Investment Split
as of March 31, 1988



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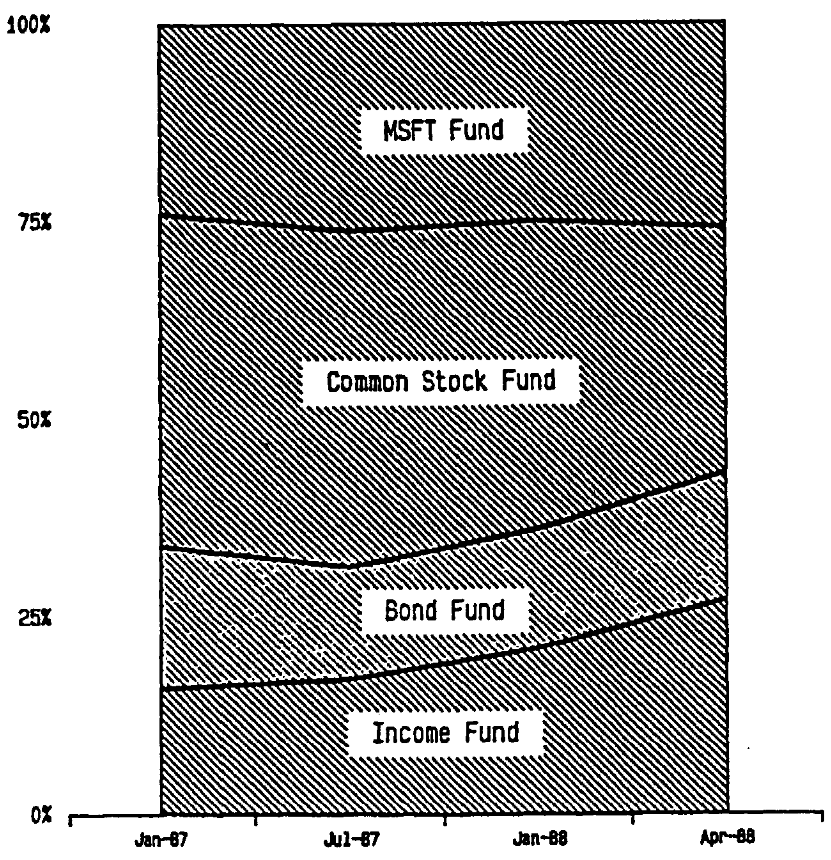
Savings Plus
Investment Option Participation



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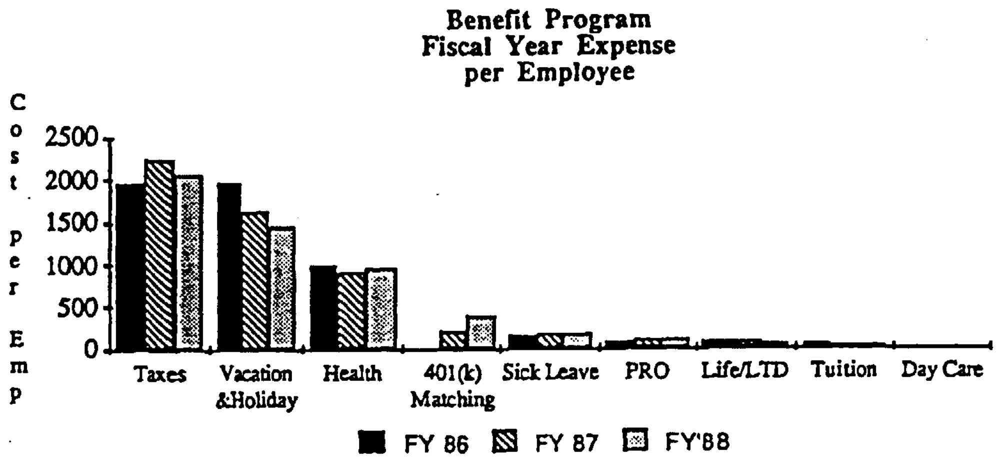
The Savings Plus Plan passed its first annual anti-discrimination and average deferral percentage (ADP) tests for calendar year 1987, as required by IRS regulations to ensure the plan is not discriminating in favor of the highly compensated employees. The favorable test results are significant as revisions from Tax Reform 1986 have prevented many large corporations from passing, resulting in contributions being refunded to the highly compensated employees. We do not anticipate any problems with the rules for calendar year 1988.

Employee Benefits

Our percentage of employees eligible to participate in our full benefit plan continues to drop to only 87%. This has contributed to the reduction of our cost per employee, in some program areas, such as vacation and holiday time. In our health care plans the lack of participation by 13% of the workforce has helped hold our costs steady. Considering the high quality of our plan, in comparison to area employers, it is interesting to note the highest benefit costs in the corporation are employment taxes and statutory benefit employer contributions.



Recruiting

Microsoft continues to grow, adding 162 employees to our domestic operations in this quarter. Domestic operations had a net growth of 8.7% and international operations 4.5%. Our employment mix of exempt and non-exempt has not changed significantly, with uniform growth in both classifications (see the following charts, Number of Employees Domestic and International Headcount and Domestic Employee Analysis). The employment of temporary and part-time employees continues to expand and now comprises 13% of our total domestic staff.

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Employee Relations

A proactive employee relations program was developed to support the move of Manufacturing and Distribution to the new facility. A strategy was laid out including employee communications, training, facility orientation and local area introduction. Methods included small plant tours prior to the move, local area directories, and timely communication of all developments.

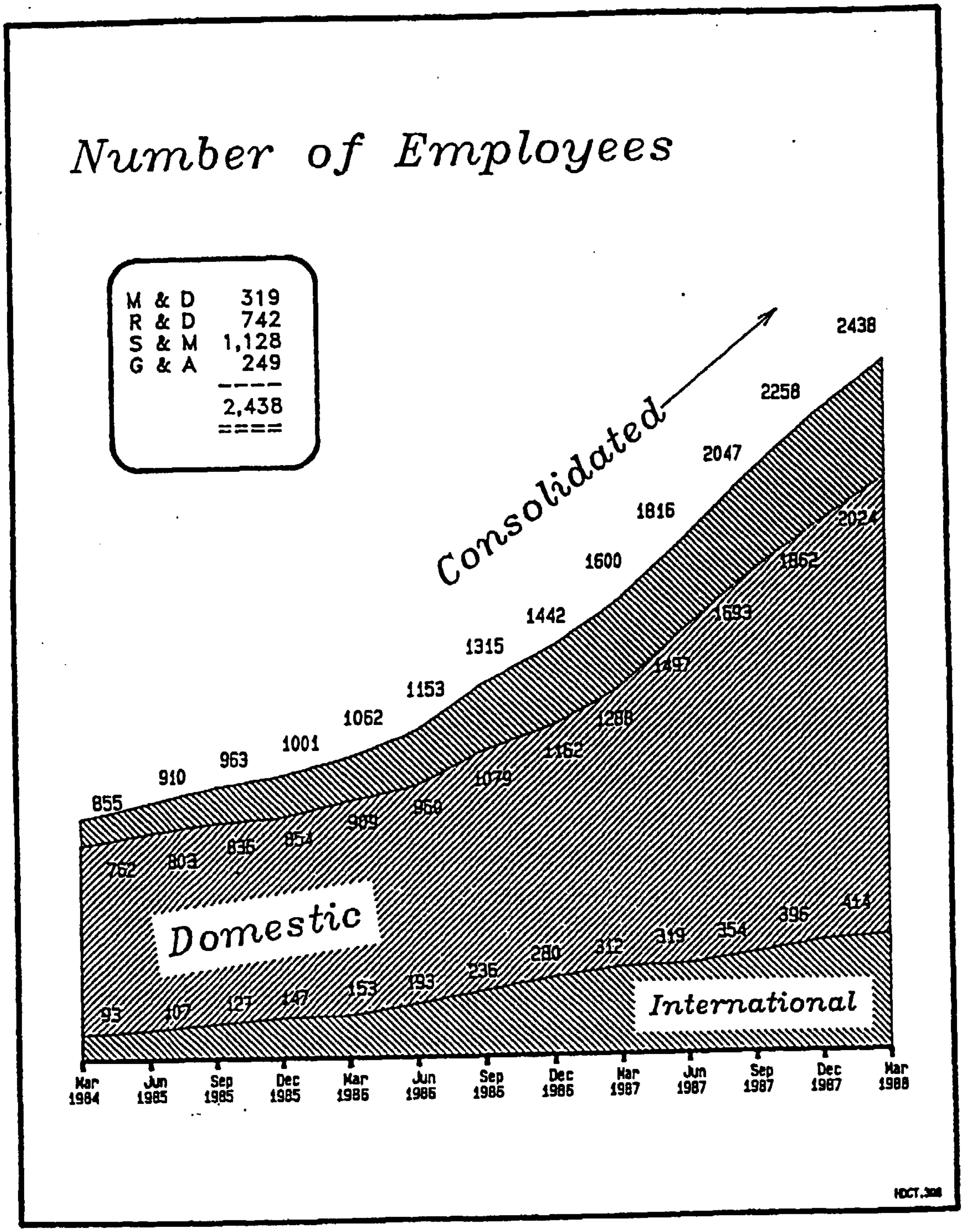
The recent interest by the Teamsters in our manufacturing employees seems to have faded. Meetings were held with all managers and supervisors on what to look for and how to conduct themselves. Proactive programs are being put in place by our resident personnel administrator.

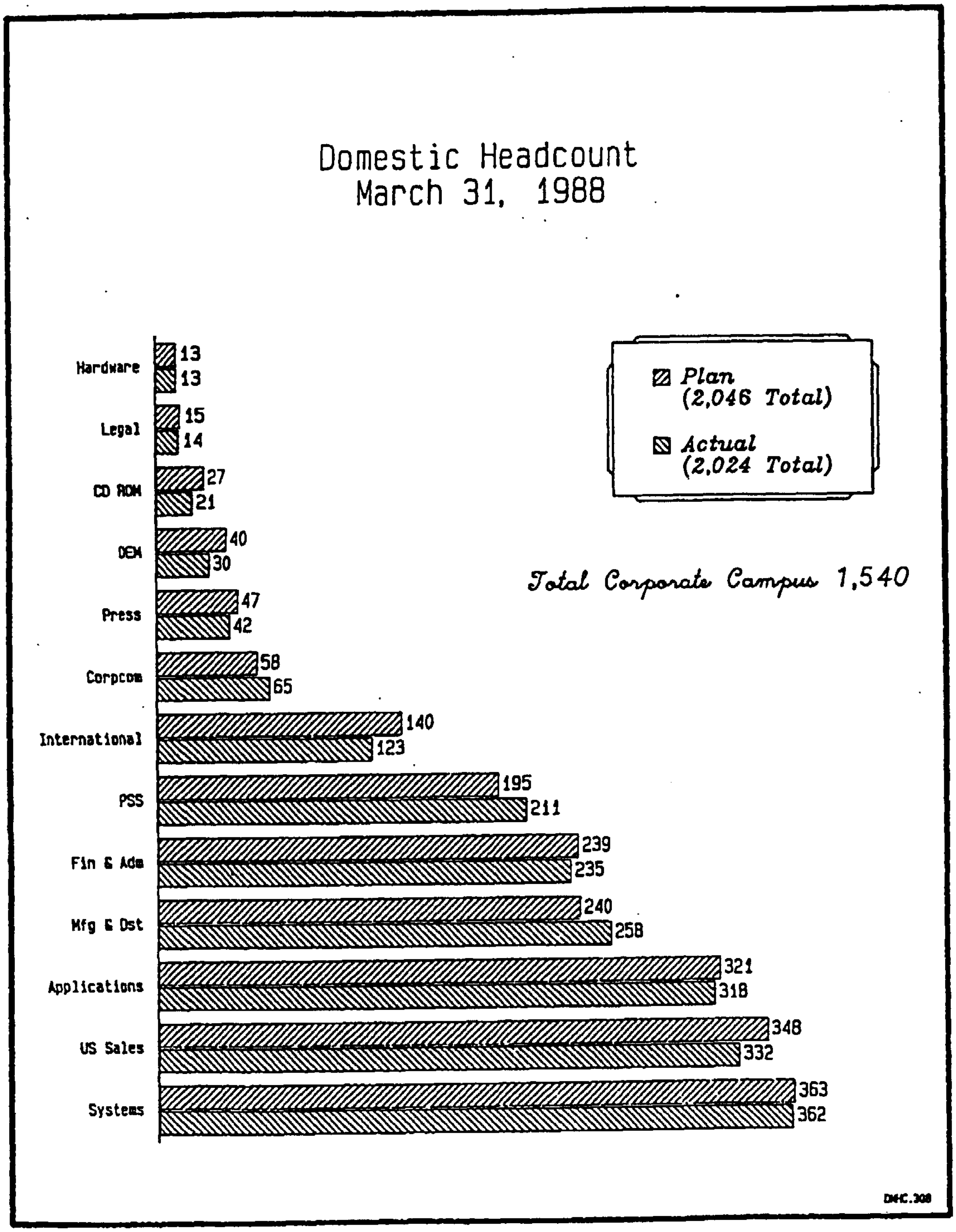
Compensation

Recent surveys conducted for software design engineers, editors, writers and all non-exempt manufacturing positions have provided up-to-date points of comparison for these positions. We have found our rates of pay, benefit package and employment practices to be competitive with our industry and the local area. Internal equity was verified for those positions and is sound.

Management Development

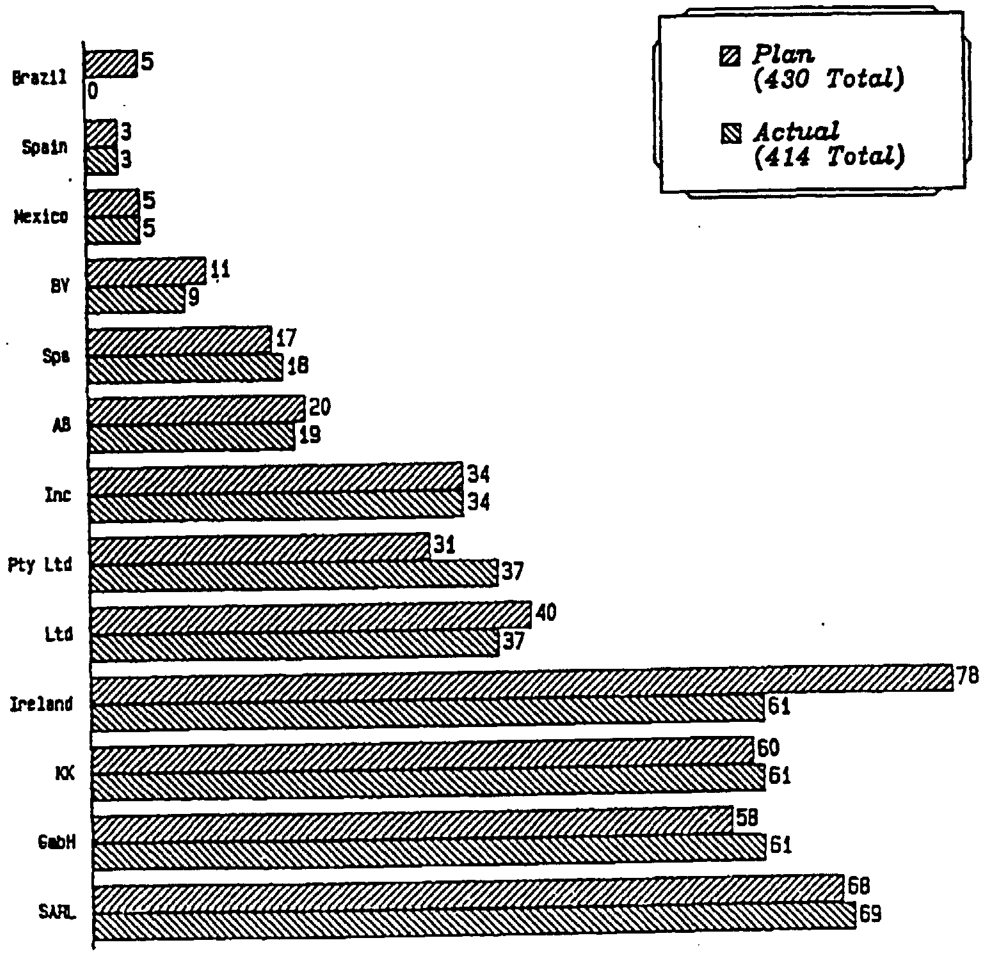
An internal study is underway to identify the background and source of current leadership talent, define the dimensions of leadership needed in the future and design training, performance evaluation and other developmental strategies for high potential individuals. A preliminary outcome of that work is a training program which applies management communications skills to the multiple topics of the performance review. The beta test conducted in early April was very successful. The course will be made available to all managers and supervisors through a flexible multi session format. The focus on leadership development will have positive outcomes in the preparation of current staff members for the critical management positions needed for our sustained growth.

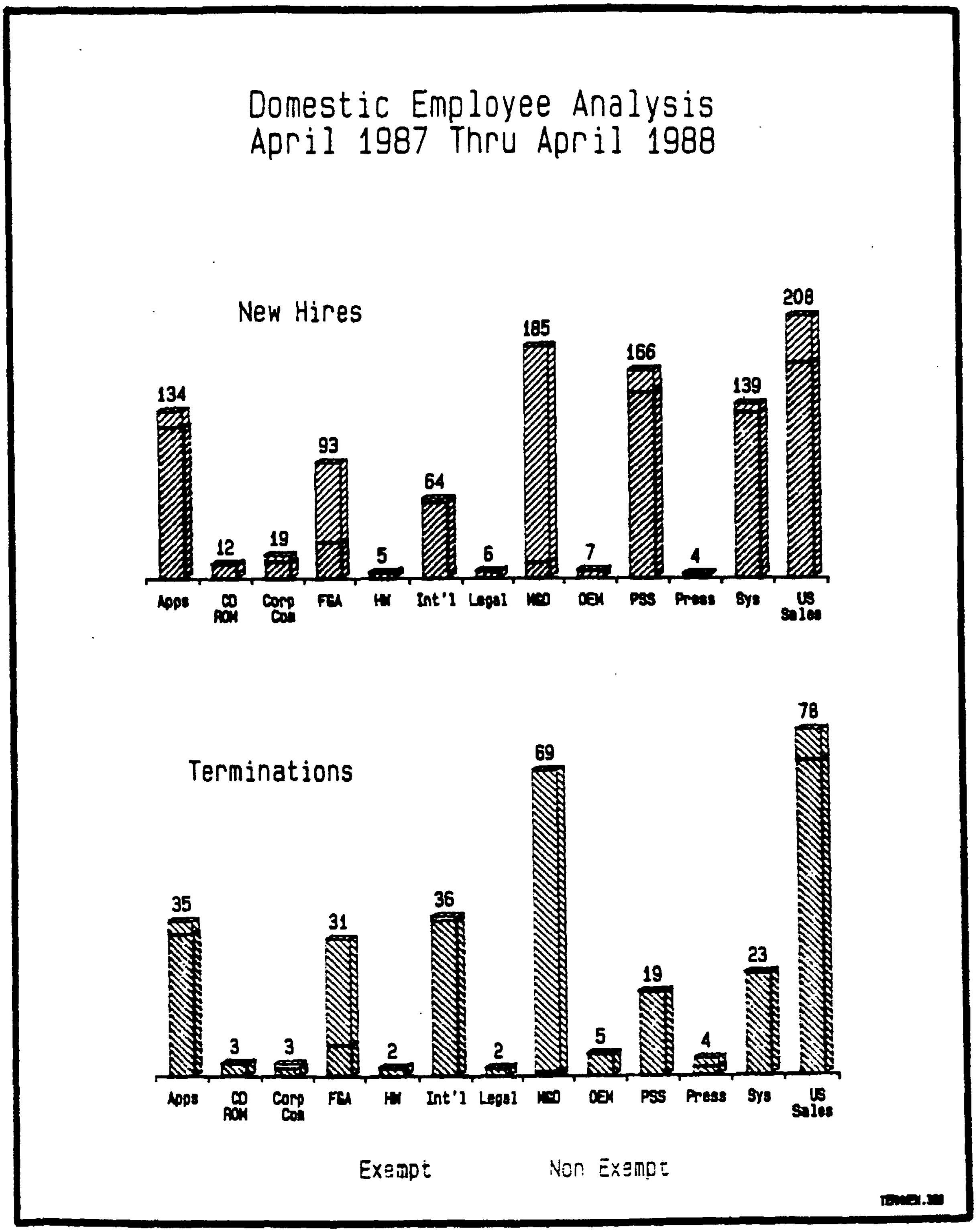

Number of Employees
M & D 319
R & D 742
S & M 1,128
G & A 249
2,438
Consolidated
Domestic
International
855
910
963
1001
1062
1153
1315
1442
1600
1816
2047
2258
2438
762
803
836
854
909
960
1079
1162
1288
1497
1693
1862
2024
93
107
127
147
153
193
236
280
312
319
354
396
414
Mar 1984
Jun 1985
Sep 1985
Dec 1985
Mar 1986
Jun 1986
Sep 1986
Dec 1986
Mar 1987
Jun 1987
Sep 1987
Dec 1987
Mar 1988



Domestic Headcount
March 31, 1988
Plan
(2,046 Total)
Actual
(2,024 Total)
Total Corporate Campus 1,540
Hardware
13
13
Legal
15
14
CD ROM
27
21
OEM
40
30
Press
47
42
Corpcom
58
65
International
140
123
PSS
195
211
Fin & Adm
239
235
Mfg & Dst
240
258
Applications
321
318
US Sales
348
332
Systems
363
362

International Headcount
March 31, 1988




Domestic Employee Analysis
April 1987 Thru April 1988
New Hires
134
12
19
93
5
64
6
185
7
166
4
139
208
Apps
CD ROM
Corp Com
FEA
HW
Int'l
Legal
MED
OEM
PSS
Press
Sys
US Sales
Terminations
35
3
3
31
2
36
2
69
5
19
4
23
78
Apps
CD ROM
Corp Com
FEA
HW
Int'l
Legal
MED
OEM
PSS
Press
Sys
US Sales
Exempt
Non Exempt