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Board of Directors' Report

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October 27, 1996

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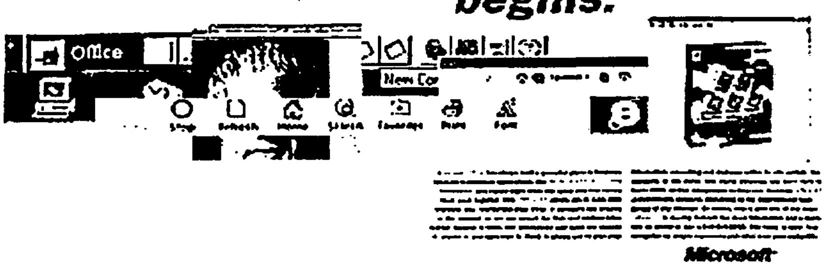
BOARD OF DIRECTORS' REPORT

Microsoft Office 97 makes it hard to tell where your desktop ends and the Internet begins.



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Q97-2 Board of Directors' Report

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This report was prepared with Word for Windows 97. All tables were created in Excel 97 and either embedded in the document or linked to master spreadsheets. Additionally, most of the channel and product group tables were generated via automation from the general ledger. Each of these automated tables is made accurate in its calculations by using data at a lower level than the rounded amounts shown in this report. These lower level amounts are used to calculate variances and are then rounded and displayed in this report. Therefore, individual amounts are rounded perfectly but totals and variances may not foot precisely. All other tables have individual numbers that may be rounded. While these individual numbers may not tie precisely to supporting schedules, they will foot exactly as shown in this report.

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Microsoft Results

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EXECUTIVE SUMMARY

MICROSOFT CORPORATION INCOME STATEMENT

GAAP RESULTS

(In millions, except earnings per share)	Q97-2		Q96-2		Growth	Q97-1		Growth	Year to date	
Net revenue	$2,680	100%	$2,195	100%	22%	$2,295	100%	17%	$4,976	100%
Operating expenses:										
Cost of revenue	296	11.0%	330	15.0%	(10%)	250	10.9%	18%	546	11%
Research & development	485	18.1%	313	14.2%	55%	432	18.8%	12%	917	18%
Sales & marketing	737	27.5%	690	31.4%	7%	625	27.2%	18%	1,362	27%
General & administative	81	3.0%	77	3.5%	6%	86	3.7%	(5%)	167	3%
Total operating expenses	1,599	59.7%	1,409	64.2%	14%	1,393	60.7%	15%	2,992	60%
Operating income	1,081	40.3%	786	35.8%	38%	902	39.3%	20%	1,983	40%
Interest income	105	3.9%	76	3.5%	37%	92	4.0%	14%	196	4%
Other expenses	(46)	-	23	-	nm	(49)	-	(6%)	(95)	0%
Income before income taxes	1,140	42.5%	885	40.3%	29%	945	41.2%	21%	2,084	42%
Provision for income taxes	(399)	(14.9%)	(310)	(14.1%)	29%	(331)	(14.4%)	21%	(730)	(15%)
Net income	$741	27.6%	$575	26.2%	29%	$614	26.7%	21%	$1,354	27%
Earnings per share *	$ 0.57		$ 0.45		26%	$ 0.47		20%	$ 1.04	
Weighted avg shares outstanding *	1,304		1,275			1,293			1,298	

	Q97-2	Q97-1	Q96-4	Q96-3	Q96-2	Q96-1	Q95-4	Q95-3
Net revenue (in millions)	$2,680	$2,295	$2,255	$2,205	$2,195	$2,016	$1,621	$1,587
Operating inc. (% of net revenue)	40.0%	39.3%	35.9%	35.1%	35.8%	35.1%	32.8%	34.6%
Net income (% of net revenue)	27.4%	26.8%	24.8%	25.5%	26.2%	24.8%	22.7%	25.0%
Earnings per share *	$0.57	$0.47	$0.43	$0.44	$0.45	$0.39	$0.29	$0.32

** Prior periods adjusted for December 1996 two-for-one stock split*

Q97-2 Highlights

- GAAP revenue was $2.68 billion, an increase of 22% over the comparative quarter in FY96 and 17% over the sequential quarter. Year over year growth was primarily driven by sales of Windows 95, Office and Office Pro, and BackOffice products. Windows 95, with $732 million of gross revenue in Q97-2, was 81% over sell-thru revenue of $405 million in Q96-2. OEM had a huge quarter, exceeding $1 billion on an internal management basis. Unearned revenue related to operating systems, Office coupons and maintenance contracts totaled $1.01 billion at December 31, 1996.
- Cost of revenue as a percent of net revenue declined to 11.0% from 15.0% in Q96-2. Costs were higher a year ago primarily because of $62 million of obsolete inventory accruals. Increased corporate licensing and increased shipment of products on CD-ROM also contributed the decline in costs of goods.
- Research & development costs, representing 18% of net revenue, grew 55% over the prior year's quarter and 12% over Q97-1. Increased R&D costs occurred across all product divisions. Increases were primarily driven by headcount-related costs and third party development, which included write-offs of purchased intellectual property.
- Sales and marketing expenses as a percent of net revenue declined by 3 percentage points due to marketing and support costs associated with the launch of Windows 95 and Office 95 last year.
- Other expenses include funding of MSNBC and DreamWorks joint venture at $64 million.
- Net income for the quarter totaled $741 million, a 29% increase over Q96-2 and 21% over the sequential quarter. Split adjusted earnings per share increased 26% to $0.57

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CONSOLIDATED MANAGEMENT P&L

INTERNAL MANAGEMENT RESULTS

($ in millions)	Q97-2					Year to date				
	Actual		Budget		Var %	Actual		Budget		Var %
Gross revenue (as billed)	$3,412.3	106%	$2,900.0	105%	18%	$5,942.0	104%	$5,112.3	104%	16%
Revenue adjustments	(195.3)	(6%)	(138.6)	(5%)	41%	(243.3)	(4%)	(209.0)	(4%)	16%
Net revenue	3,217.0	100%	2,761.4	100%	16%	5,698.7	100%	4,903.4	100%	16%
Cost of revenue	334.8	10.4%	369.4	13.4%	(9%)	593.9	10.4%	660.3	13.5%	(10%)
Gross profit	2,882.3	89.6%	2,392.0	86.6%	20%	5,104.7	89.6%	4,243.1	86.5%	20%
Operating expenses:										
Product development:										
Platforms & Applications	291.1	9.0%	319.1	11.6%	(9%)	550.3	9.7%	640.4	13.1%	(14%)
Interactive Media	123.5	3.8%	158.7	5.7%	(22%)	226.1	4.0%	312.0	6.4%	(28%)
Interactive Media Invest.	23.6	0.7%	32.6	1.2%	(28%)	52.3	0.9%	70.7	1.4%	(26%)
Product Marketing	97.0	3.0%	105.7	3.8%	(8%)	147.7	2.6%	183.2	3.7%	(19%)
Other	15.1	0.5%	7.4	0.3%	105%	31.8	0.6%	14.4	0.3%	120%
	550.3	17.1%	623.5	22.6%	(12%)	1,008.2	17.7%	1,220.7	24.9%	(17%)
Sales & marketing:										
Sales expense	259.0	8.0%	273.8	9.9%	95%	498.0	8.7%	546.7	11.1%	91%
Marketing	176.3	5.5%	180.7	6.5%	98%	277.7	4.9%	337.1	6.9%	82%
Broad Reach	28.9	0.9%	27.7	1.0%	104%	52.0	0.9%	55.5	1.1%	94%
Product support	109.2	3.4%	112.7	4.1%	97%	213.7	3.7%	233.6	4.8%	91%
	573.3	17.8%	594.9	21.5%	96%	1,041.4	18.3%	1,172.9	23.9%	89%
General & administrative	63.4	2.0%	75.9	2.7%	84%	124.2	2.2%	146.2	3.0%	85%
Total operating expenses	1,187.0	36.9%	1,294.3	46.9%	92%	2,173.7	38.1%	2,539.8	51.8%	86%
Operating income	$1,695.2	52.7%	$1,097.7	39.8%	154%	$2,931.0	51.4%	$1,703.3	34.7%	172%
Avg worldwide headcount	20,876		22,962		91%	20,722		22,778		91%

	Q97-2	Q97-1	Q96-4	Q96-3	Q96-2	Q96-1	Q95-4	Q95-3
Cost of sales % of net revenue	10.4%	10.5%	12.3%	13.2%	15.5%	15.1%	14.4%	14.8%
Marketing expense % of net revenue	9.4%	7.1%	13.4%	7.4%	11.4%	11.6%	9.0%	11.3%
Product dev. expense % of net revenue	14.1%	16.5%	17.8%	15.1%	13.7%	15.3%	16.3%	13.8%
PSS expense % of net revenue	3.4%	4.2%	5.0%	5.1%	6.0%	5.4%	6.4%	5.1%
Average worldwide headcount	20,876	20,566	20,406	20,016	19,399	18,416	17,534	16,873

NOTES TO CONSOLIDATED MANAGEMENT REPORTS

The consolidated management P&L is based on functional responsibility and prepared in accordance with MAP (Microsoft Accounting Principles). These results include the impact of certain adjustments and reclassifications as required by Generally Accepted Accounting Principles (GAAP) for external reporting and exclude non-operating items and income taxes. Significant differences between financial statements prepared for internal management use and externally reported results include:

- Revenue for internal management reports is generally recognized "as billed." Under GAAP, net revenue includes adjustment for certain billed, but unearned revenue, such as a portion of operating system revenue that will be recognized over the product life cycle. Conversely, certain revenue that is earned but not yet billed, such as unreported OEM and Select revenue, is also recognized for external purposes.
- For external reporting purposes, the net cost of MSN operations is included as research and development expenses. For internal management reporting, MSN revenue and cost of operations are shown grossed up as a business channel.
- Interactive Media Investments represent Microsoft's share of joint venture operating loss. These product development costs are reflected as non-operating expenses for GAAP purposes.
- For external reporting purposes, all product marketing related activities are classified as a sales and marketing expense. For internal reporting purposes, product marketing departments and related marketing expenses are included in product development.

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REVENUE SUMMARY

Gross Product Revenue
(Revsum categories as shipped, in millions)

	Q97-2 Actual	% of Total	Var % to Plan	Var % to Q96-2*	YTD Actual	% of Total	Var % to Plan	Var % to FY96*
Office (incl Pro)	$919.8	27%	20%	29%	$1,631.3	27%	15%	27%
Windows 95	731.8	21%	25%	81%	1,289.3	22%	26%	79%
NT Workstation	160.8	5%	57%	268%	270.7	5%	70%	281%
NT Server (incl CALs)	165.9	5%	42%	142%	300.4	5%	51%	173%
Windows 3.x & MS-DOS	142.1	4%	2%	(61%)	295.8	5%	8%	(62%)
Interactive Media	225.2	7%	8%	112%	293.7	5%	0%	78%
Internet Platforms & Tools	123.4	4%	(15%)	(16%)	244.0	4%	(3%)	(13%)
Hardware	133.8	4%	(7%)	32%	213.7	4%	(3%)	4%
All other products	808.9	24%	(4%)	17%	1,616.8	27%	8%	30%
Gross revenue	$3,411.8	100%	18%	29%	$5,942.0	100%	16%	23%

** Prior periods adjusted for Desktop95 reserve*

- Gross revenue topped $3.41 billion. 18% over plan and 29% ahead of Q96-2. The prior year was adjusted for excess inventory of Desktop 95 products. In the quarter, revenue growth over plan was driven primarily by Office (including Professional, 20% over plan) and Windows 95 (25% over plan). Year over year quarterly growth of 29% was driven by Windows 95 (+$327 million), Office and Office Pro (+$209 million), and Windows NT Workstation (+$117 million).
- Desktop Applications gross revenue totaled $1.36 billion, 16% over plan, driven primarily by Office and Office Pro which, combined, were 20% over planned. Office and Office Pro revenues grew $97 million (29%) from Q97-1 to $920 million in the quarter. Select (+$57 million) and Office 97 package product (+$107 million) drove most of the gains. The English version of Office 97 was released into the channel in December.
- Revenues from Windows 95 and Windows NT Workstation made up 82% of the total Desktop Systems division revenues of $1.09 billion for the quarter. The OEM channel accounted 82% or $600 million of Windows 95 revenue in the quarter, growing 153% over the same period last year driven by strong PC shipments. Windows NT Workstation reported strong results in all geographies, particularly in the Far East with the release of Japanese language of Version 4.0 on December 10th.
- BackOffice product revenues for the quarter totaled $358 million, 19% over plan and 108% over prior year with Windows NT Server (including user licenses) accounting for most of the plan variance and year over year growth.
- Interactive Media revenues, including MSN billings, were 8% above plan for the quarter and 112% over prior year due to the launch and success of Encarta 97 and Entertainment titles such as the Windows 95 version of Flight Simulator and Deadly Tide. MSN had approximately 1.8 million subscribers at the end of the quarter and monthly subscription billings were current as of December 14th.
- The negative variance of Internet Platform and Tools division revenues reflects the slip in the release of Visual Basic 5.0 to Q97-3. This was partially offset by robust MSDN subscriptions, which were 30% over plan for the quarter and grew 100% over the comparable quarter.
- Slower than planned keyboard sales was the main driver of the 7% negative variance to plan for the Hardware division. All hardware products, particularly Mouse which was up 26%, grew over Q96-2 levels.

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Gross Channel Revenue (in millions)	Q97-2 Actual	% of Total	Var % to Plan	Var % to Q96-2*	YTD Actual	% of Total	Var % to Plan	Var % to FY96*
North America FG	$1,028.6	30%	11%	36%	$1,883.1	32%	15%	26%
Europe FG	789.3	23%	24%	21%	1,251.5	21%	19%	9%
ICON FG	215.9	6%	7%	54%	374.3	6%	3%	28%
Far East FG	292.7	9%	27%	27%	552.0	9%	22%	40%
Total finished goods	2,326.5	68%	16%	31%	4,060.9	68%	16%	22%
OEM	992.3	29%	23%	39%	1,740.2	29%	20%	41%
Other	93.0	3%	(3%)	104%	140.9	2%	(14%)	88%
Net revenue	$3,411.8	100%	18%	34%	$5,942.0	100%	16%	28%

** FY96 Adjusted for Desktop95 reserve*

- Finished goods channel revenue for the quarter was $2.33 billion, 16% over plan and 31% over Q96-2 after adjusting for Desktop 95 reserves. All regions were above plan and grew substantially over prior year with Office and Office Pro, Windows 95 and Windows NT accounting for a large part of the variance. Office and Office Pro showed robust sales despite the channel dry in the US as Select billings (including maintenance) in Europe grew 27% over Q97-1 to $237 million in the quarter.
- English versions of Office 97 were sold into the channel in the United States, United Kingdom, Australia and New Zealand with shipment of localized versions projected for Q97-3.
- OEM billings for the quarter topped $992 billion, 23% over plan and growing 39% over prior year driven primarily by continued strong worldwide PC growth. OEM net revenues, as measured internally, topped $1 billion. Windows 95 is estimated to have been installed in 78% of the PCs shipped worldwide.

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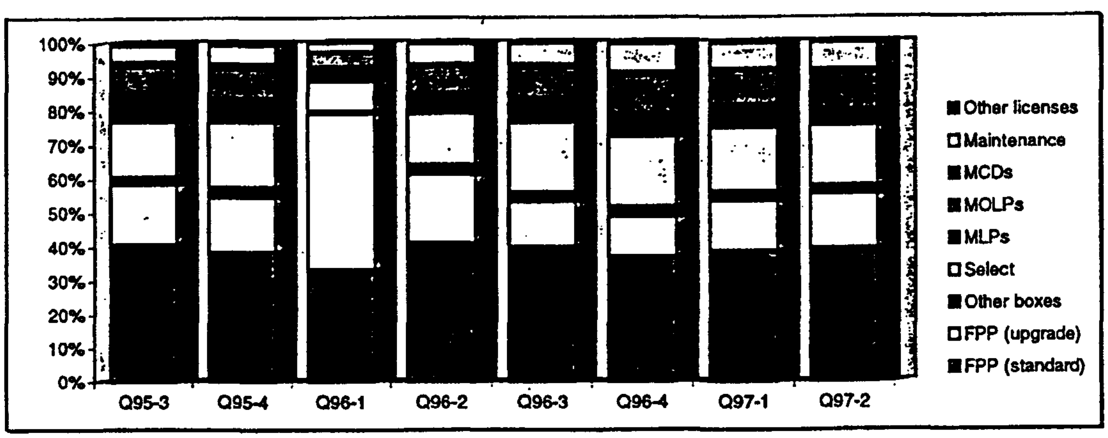
Gross shipments (excludes returns) based on revenue



- Q97-2 sales of packaged product (including upgrades) accounted for about 58% of total finished goods revenue compared to 64% in Q96-2 and 56% in Q97-1. Shipments in Q97-2 reflected the sell-in of Office 97 packaged product and shipments of Interactive Media titles for the holiday season. The abnormal increase in FPP in Q96-1 reflects initial sell-in of Windows 95 and Office 95 into the retail channel.
- Select billings (including Select maintenance), accounting 60% of all licensed products, for the quarter totaled $603 million, 35% over Q97-1 and 48% over Q96-2. Billings for DAD products were the primary driver of Select revenue, accounting for $398 million of the total, 16% over plan and growing 34% over last year. Year to date Select revenues were at $1.04 billion, 20% over plan and 54% over the same period last year.

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Foreign Exchange Impact on Consolidated Gross Revenue

(in millions)	Q97-2 Variance to plan					Year to date variance to plan				
	Volume	FX	FX %	Total	Total %	Volume	FX	FX %	Total	Total %
North America FG	$101.9	$0.0	0.0%	$101.9	11.0%	$250.5	$0.1	0.0%	$250.5	15.3%
Europe FG	117.8	33.5	5.3%	151.3	23.7%	151.3	49.1	4.7%	200.4	19.1%
ICON FG	11.0	2.5	1.2%	13.5	6.7%	6.6	3.7	1.0%	10.3	2.8%
Far East FG	50.0	11.5	5.0%	61.5	26.6%	69.5	29.6	6.5%	99.0	21.9%
OEM & Channels	182.7	0.9	0.1%	183.6	20.4%	268.2	1.1	0.1%	269.4	16.7%
Total	$463.4	$48.4	1.7%	$511.8	17.6%	$746.1	$83.6	1.6%	$829.7	16.2%

- Actual foreign exchange rates, compared to planned rates, continue to be positive resulting in a $48 million (1.7 points) bump to gross revenues.
- As shown below, the US dollar was weaker than planned against most major European currencies resulting in positive revenue variance of $34 million for the quarter.

Currency	Rates per dollar Actual	Budget	Var%
British Pound	0.61	0.67	9%
Duetsche Mark	1.51	1.60	6%
French Franc	5.11	5.25	3%
Italian Lira	1,526.48	1,600.00	5%

- A weaker than planned dollar-to-yen exchange rate continues to prevail in Japan, resulting in a $12 million positive foreign exchange variance for the year in the Far East FG channel. During the quarter, the translation rate for financials averaged 109.65 Yen per dollar compared to a budget rate of 115 Yen.

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COST OF REVENUE

Cost of Revenue - Q97-2 (as a % of net revenue)	Sales Mix	Wghted Avg Cost	Cost of Revenue Actual	Cost of Revenue Plan
By Channel				
North America FG	28.4%	3.1%	10.8%	16.2%
Europe FG	23.3%	2.6%	11.3%	13.6%
ICON FG	6.2%	0.8%	13.0%	17.9%
Far East FG	8.7%	0.9%	10.2%	13.8%
Total Finished Goods	66.6%	7.4%	11.1%	15.2%
OEM	31.2%	1.1%	3.4%	4.1%
Other (includes MSN)	2.1%	2.0%	92.8%	57.2%
	100.0%	10.4%	10.4%	13.4%
By Product Division				
Desktop Apps	39.2%	2.4%	6.2%	9.3%
Desktop Systems	33.5%	0.8%	2.5%	4.0%
Business Systems	12.3%	0.9%	6.9%	10.6%
Internet Platform & Tools	3.7%	1.0%	26.3%	23.6%
Consumer Platforms	0.0%	0.0%	0.0%	nm
Softimage	0.3%	0.0%	5.7%	9.9%
Platforms & Applications	88.9%	5.1%	5.7%	8.4%
Interactive Media	4.7%	2.7%	56.9%	42.4%
Hardware	3.9%	2.0%	51.5%	52.7%
Desktop Finance	0.3%	0.1%	25.5%	36.9%
Interactive Media Group	9.0%	4.8%	53.4%	46.5%
Other (primarily MS Press)	2.1%	0.5%	23.4%	45.9%
	100.0%	10.4%	10.4%	13.4%

- Cost of revenue for the quarter was 10.4% internal management net revenues, 3 points below plan primarily due to a favorable mix of high margin products, CD-ROM media and licensed product sales. Cost of revenue was about even with Q97-1 and 5 points better than Q96-2.
- Desktop and Business operating systems and Desktop Aapplications, which carry a higher margin than Hardware and Interactive Media products, accounted for 85% of finished goods revenues compared to a plan mix of 81%.
- CD-ROM media made up 83% of the non-hardware package product licenses for the quarter compared to a budget of 70% and Q97-1 mix of 68%. Higher than plan CD-ROM media sales of Office 97, Encarta 97, Windows 95 and Windows NT drove the higher CD-ROM media mix in the quarter. Packaged product versions of Office 97 are shipped on CD-ROM only with diskette (44 diskettes for Office Pro) media available upon request.
- Cost of revenue in the Interactive Media division includes costs associated with MSN operations which are 30% over plan due to higher telecommunication costs.

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OPERATING EXPENSES
(in millions)

	Q97-2			Year to date		
	Actual	Plan	Var %	Actual	Plan	Var %
People costs	$455.0	$507.8	10%	$892.9	$1,007.0	11%
Contingent staff and outsourcing	151.1	144.2	(5%)	283.1	289.3	2%
Infrastructure costs	158.2	180.3	12%	301.2	345.4	13%
Marketing expenses	309.1	318.4	3%	486.3	584.3	17%
PSS/MCS cost recovery	(99.6)	(94.1)	6%	(177.0)	(171.6)	3%
Third party product development	83.8	113.8	26%	146.4	238.9	39%
Other misc. expenses	129.5	123.9	(5%)	240.9	246.6	2%
	$1,187.0	$1,294.3	8%	$2,173.7	$2,539.8	14%
Avg non-operations headcount	19,719	21,605	9%	19,486	21,245	8%
People cost per head	$92,293	$94,021	2%	$91,640	$94,797	3%
Infrastructure cost per head (annualized cost per average MS head)	$32,081	$33,380	4%	$30,910	$32,517	5%
Contingent staff and outsourcing (as a percentage of People costs)	33.2%	28.4%		31.7%	28.7%	

(Note: excludes heads and expenses related to Operations included in Cost of Revenue)

- Q97-2 operating expenses were $1.19 billion, 8% below plan for the quarter driven by lower headcount. slower than budgeted implementation of marketing programs and below plan spending on third party development.

- People costs per head were 2% below budget due to lower payroll and payroll tax expenses. On a year to date basis, cost per head was 3% below plan as travel, recruiting and supplies spending were lower than budgeted while payroll expenses were even with plan.

- Contingent staff expense was 5% above plan for the quarter as divisions outsourced and hired temporary help to substitute for regular heads. Total regular operating headcount at the end of December was at 19,830, 9% or 1,972 heads below budget.

- Q97-2 Infrastructure costs totaled $158 million, 12% below plan, driven by below plan PC depreciation expense. Total depreciation expense for the quarter was $76 million, 19% below plan due to lower headcount levels. Infrastructure costs per head were 4% below plan due to lower depreciation expense which was 11% below plan.

- Marketing expenses in the quarter were much higher than Q97-1 but were still $9 million (3%) below the quarter plan. Channel marketing for quarter was above plan in all regions except the Far East but all regions were below plan on a year to date basis. Product marketing was $97 million in the quarter, 17% under plan.

- Q97-2 MCS revenue was $4 million (8%) over plan with higher than plan subcontractor revenue being partially offset by consultant revenue. PSS cost was $1 million (2%) over plan.

- Third party product development charged to the product groups continue to be below plan but at a much lower level than Q97-1 as localization spending increased to meet Q97-3 and Q97-4 ship dates.

- Other expenses, which include bad debts, taxes & licenses and miscellaneous operating expenses, were $5 million (5%) above plan due to revenue driven higher bad debt expenses (30% over plan) and taxes and licenses (23% over plan) partially offset by lower than plan joint venture expenses.

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Product Group Costs
(in millions)

	Q97-2					Year to date				
	Actual		Plan		Var %	Actual		Plan		Var %
Platform & Applications Group										
Desktop Applications	$67.4	12%	$78.6	13%	14%	$124.2	12%	$158.5	13%	22%
Desktop Systems	9.1	2%	10.7	2%	15%	16.8	2%	22.8	2%	27%
Business Systems	102.3	19%	102.2	16%	(0%)	194.4	19%	207.0	17%	6%
Internet Platforms & Tools	87.2	16%	89.9	14%	3%	163.3	16%	178.2	15%	8%
Consumer Platforms	8.5	2%	11.0	2%	23%	18.2	2%	21.3	2%	15%
Softimage	6.2	1%	8.3	1%	26%	12.0	1%	17.0	1%	30%
Group Management	10.5	2%	18.4	3%	43%	21.2	2%	35.6	3%	41%
Total	291.1	53%	319.1	51%	9%	550.1	55%	640.4	52%	14%
Interactive Media Group										
Interactive Media	$98.9	18%	$128.1	21%	23%	$179.0	18%	$252.5	21%	29%
Desktop Finance	4.3	1%	6.3	1%	31%	8.5	1%	13.0	1%	35%
Hardware	12.6	2%	12.1	2%	(4%)	23.4	2%	23.8	2%	2%
Group Management	7.7	1%	12.1	2%	37%	15.2	2%	22.7	2%	33%
Total	123.5	22%	158.7	25%	22%	226.1	22%	312.0	26%	28%
Product Marketing	97.0	18%	105.7	17%	8%	147.7	15%	183.2	15%	19%
Interactive Media Investments	23.6	4%	32.6	5%	28%	52.3	5%	70.7	6%	26%
Other	15.1	3%	7.4	1%	(105%)	31.9	3%	14.4	1%	(121%)
Total	$550.3	100%	$623.5	100%	12%	$1,008.2	100%	$1,220.7	100%	17%

- Q97-2 product group costs totaled $550 million, $73 million (12%) below plan as headcount continues to be below planned levels across all divisions in addition to lower than plan product marketing and third party development spending.
- Platforms and Applications Group average headcount for the quarter was 6% below plan and the Interactive Media Group average headcount was about 13% below plan.
- Third party development spending was $12 million (22%) below plan in Platforms and Applications Group and $20 million (36%) below plan in the Interactive Media. Planned spending levels are expected to be reached as we get closer to the RTM of localized versions of Office 97.
- Interactive Media investment costs for the quarter of $37 million ($24 million in IMI and $14 million in Other) includes $25 million for MSNBC Cable Joint Venture, $9 million for MSNBC Interactive Joint Venture and $3 million for DreamWorks Interactive.

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SALES, MARKETING & SUPPORT COSTS
(in millions)

	Q97-2					Year to date				
	Actual		Plan		Var %	Actual		Plan		Var %
Sales Expenses										
North America FG	$76.0	14%	$83.2	15%	9%	$147.2	15%	$165.7	15%	11%
Europe FG	63.3	12%	66.8	12%	5%	120.3	12%	133.3	12%	10%
ICON FG	27.0	5%	29.2	5%	8%	51.2	5%	59.1	5%	13%
Far East FG	18.5	3%	21.4	4%	14%	37.7	4%	41.9	4%	10%
OEM	33.4	6%	29.2	5%	(14%)	59.4	6%	54.6	5%	(9%)
Other	40.7	7%	44.0	8%	7%	82.1	8%	92.1	8%	11%
Total sales expenses	259.0	48%	273.8	48%	5%	498.0	50%	546.7	49%	9%
Marketing Costs	176.3	32%	180.7	32%	2%	277.7	28%	337.1	30%	18%
Broad Reach	28.9	5%	27.7	5%	(4%)	52.0	5%	55.5	5%	6%
Support Costs	109.2	20%	112.7	20%	3%	213.7	22%	233.6	21%	9%
Total	$544.5	100%	$567.2	100%	4%	$989.3	100%	$1,117.4	100%	11%

- Sales expenses for the quarter were 5% below plan as headcount continues to track below plan. Expense in the OEM channel was 14% over plan due to additional taxes, licenses and bad debt expenses, which are a function of revenue. OEM net revenues were 26% over plan.
- Channel marketing are beginning to track to plan as sales groups increase the implementation of planned marketing programs. Q97-2 marketing expenses, including Broad Reach, totaled $205 million for the quarter, 1% below plan.
- Product support costs were 3% below with plan for the quarter due to lower than planned headcount. Support costs were 3.4% of net revenue for the quarter, compared to a budget of 4.19%.

GENERAL & ADMINISTRATIVE COSTS
(in millions)

	Q97-1					Year to date				
	Actual		Plan		Var %	Actual		Plan		Var %
HR/Admin Services	$81.3	47%	$90.5	45%	10%	$157.0	47%	$182.5	46%	14%
ITG	50.6	29%	57.1	29%	11%	92.3	28%	112.2	28%	18%
Legal	17.8	10%	26.0	13%	32%	36.9	11%	51.8	13%	29%
Finance	13.0	8%	16.9	8%	23%	27.0	8%	33.6	8%	20%
Other	10.7	6%	8.9	4%	(21%)	20.0	6%	17.7	4%	(13%)
Gross G&A spending	173.4	100%	199.5	100%	13%	333.2	100%	397.8	100%	16%
Distribution	(110.0)		(123.6)			(209.0)		(251.7)		
Total	$63.4		$75.9			$124.2		$146.2		

- General and administrative costs include corporate cost centers that support MS on a worldwide basis. Net expenses, after distributions, include IT project development and regional support, corporate finance, legal and corporate affairs, HR services such as employee development, compensation and recruiting, and certain worldwide real estate and administrative support services. Distributed costs included employee benefits, ITG support, real estate expenses and services such as the copy center and company store.
- For the quarter, net general and administrative costs were $63 million or 1.9% of net revenue compared to a plan of 2.7% of net revenue. Gross G&A costs were 13% below plan as headcount continues to be lower than plan headcount across all groups. G&A headcount at the end of the quarter was 1,958, 13% below plan.

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CASH FLOW SUMMARY

	Q97-1	Q97-2	Change
Beginning cash & equivalents	$2,601	$3,018	$417
Cash flow from operations			
Net income	614	741	127
Depreciation	162	144	(18)
Current liabilities	227	482	255
Accounts receivable	(205)	(121)	84
Other current assets	(15)	(28)	(13)
Net cash from operations	783	1,218	435
Cash flow from financing			
Common stock issued	215	99	(116)
Common stock repurchased	(697)	(327)	370
Preferred stock issued	0	980	980
Stock option income tax benefits	106	120	14
Net cash from financing	(376)	872	1,248
Cash flow from investments			
Additions to property, plant and equipment	(99)	(117)	(18)
Equity investments and other	(156)	90	246
Short-term investments	259	(1,984)	(2,243)
Net cash used for investments	4	(2,011)	(2,015)
Net change in cash and equivalents	411	79	(332)
Effect of exchange rates on cash and equivalents	6	(1)	(7)
Ending balance of cash and equivalents	3,018	3,096	78
Ending balance of short term investments	4,080	6,064	1,984
Ending cash & short term investments	$7,098	$9,160	$2,062

- Cash and short term investments were $9.16 billion, $2.06 billion higher than Q97-1 and $3.14 billion greater than a year ago. Proceeds from the sale of preferred stock netted $980 million.
- Cash from operations increased by $435 million from the prior quarter primarily due to stronger revenues. Net revenues for the quarter were 17% higher than Q97-1.
- Net cash from financing increased from Q97-1 by $1.30 billion with 12.5 million preferred shares issued in the quarter at a price of 79.875 for a total of $980 million. The shares are convertible to common shares or cash in December 1999, pay a 2.75% annual dividend, and have a floor of $79.713. Net buy-back funding decreased to $327 million from $697 million in Q97-1.
- With the increase in the duration of the investment portfolio, investments classified as cash & equivalents decreased and securities classified as short term investments increased.

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OPERATIONAL HIGHLIGHTS

Q97-2 EXECUTIVE SUMMARY

- During the quarter, Operations continued to execute key strategies of moving toward a turnkey manufacturing model, improving the product design and release processes, and improving end-to-end Licensing and Program Operations.

WORLDWIDE PACKAGED PRODUCT

- Product, media and license mix combined with improved inventory management and expense control resulted in continued favorable cost of revenues.
- The transition of Canyon Park operations to Kao was completed during the quarter. Through December 31, Kao had produced 10.3 million units, exceeding Microsoft's contractual commitment of 8.5 million units. In addition, all production issues have been resolved. By the end of the quarter, Kao had achieved a 95% unit fill rate and we anticipate that this rate will continue.
- Consumer titles' holiday production went smoothly in all regions during the quarter. In the South Pacific and South East Asia Regions, in particular, performance was markedly improved over the same quarter last year. A concerted focus on solving problems with artwork, specification content and delivery in these regions helped Microsoft ship 475,244 units in FY97 compared to 338,947 in FY96 a 40% increase in units.

PRODUCT DESIGN AND RELEASE

- Process improvements in release labs and system changes at duplication facilities allowed for the implementation of "Combi Release" – a single release process for full packaged product and upgrade software. It is estimated that these improvements and changes saved 3,600 hours of program management, testing and support verification during the Office 97 release. It is expected that future products containing compliance checking software (software that checks for the installation of an earlier version) will utilize this new release option.

LICENSING OPERATIONS

- On November 27, Volume Licensing Operations implemented MS License 1.0. This application supports the contract administration and invoicing requirements of the new Select 4.0 program introduced during the quarter. During Q97-3 existing Select 3.0 data will be transitioned to this new system, significantly reducing customer service and report issues.

PROGRAM OPERATIONS

- Microsoft Solution Provider 97 was launched simultaneously worldwide for the first time in December. As a part of the launch, an Internet based subscription application and database capable of complex transactions required by MSP/ATEC 97 as well as future subscription programs was designed and implemented.

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COST OF REVENUE BY REGION

Q97-2 FINISHED GOODS GROSS MARGIN ANALYSIS

(In millions)

	North America				Europe				Far East				ICON				Total Finished Goods			
	Actual		Plan		Actual		Plan		Actual		Plan		Actual		Plan		Actual		Plan	
Net revenue	914.9	100.0%	843.5	100.0%	749.0	100.0%	609.0	100.0%	281.3	100.0%	221.3	100.0%	198.6	100.0%	191.7	100.0%	2,143.8	100.0%	1,865.5	100.0%
Costs of revenue:																				
Product costs	64.5	7.0%	86.6	10.3%	47.5	6.3%	44.6	7.3%	19.1	6.8%	19.6	8.9%	14.1	7.1%	19.6	10.2%	145.2	6.8%	170.3	9.1%
Royalties	12.2	1.3%	12.7	1.5%	9.1	1.2%	7.4	1.2%	3.7	1.3%	3.7	1.7%	2.7	1.4%	2.3	1.2%	27.7	1.3%	26.1	1.4%
Pipe costs	7.3	0.8%	12.9	1.5%	10.0	1.3%	10.4	1.7%	1.4	0.5%	1.7	0.8%	4.9	2.5%	6.0	3.1%	23.6	1.1%	31.0	1.7%
Obsolete & scrapped inventory	7.8	0.9%	13.9	1.6%	6.6	0.9%	8.2	1.3%	2.1	0.7%	2.5	1.1%	2.6	1.3%	4.6	2.4%	19.0	0.9%	29.2	1.6%
Channel costs	6.7	0.7%	10.4	1.2%	11.1	1.5%	12.1	2.0%	2.3	0.8%	3.0	1.4%	1.7	0.9%	1.9	1.0%	21.8	1.0%	27.4	1.5%
Total cost of revenue	98.5	10.8%	136.5	16.2%	84.3	11.3%	82.7	13.6%	28.6	10.2%	30.5	13.8%	26.9	13.0%	34.3	17.9%	237.3	11.1%	284.0	15.2%
Gross margin	816.4	89.2%	707.0	83.8%	664.7	88.7%	526.3	86.4%	252.7	89.8%	190.8	86.2%	172.7	87.0%	157.4	82.1%	1,906.5	88.9%	1,581.5	84.8%
License Mix																				
Full packaged product	55.0%		72.0%		54.0%		63.0%		58.0%		64.0%		44.0%		57.0%		54.0%		67.0%	
CD-ROM Mix, by Division																				
Desktop Applications	69%		32%		48%		30%		95%		81%		70%		26%		71%		41%	
Desktop & Business Systems	72%		54%		74%		58%		81%		71%		64%		33%		73%		55%	
Interactive Media	91%		89%		97%		81%		88%		74%		93%		85%		94%		86%	
Internet Platforms & Tools	90%		92%		86%		86%		97%		90%		78%		57%		90%		88%	
Desktop Finance	102%		58%		91%		86%		3%		45%		99%		46%		97%		72%	
Total	82%		59%		81%		59%		91%		82%		85%		45%		83%		61%	

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FINISHED GOODS COST OF REVENUE SUMMARY

- Total cost of revenues for Q97-2 were lower than plan by $46.7 million or 4.1% of net revenue due to lower total product costs, pipe costs, obsolete and scrapped inventory and channel costs. The following table summarizes the variance to plan:

[illegible]	[illegible]	[illegible]
Product costs	$ 25.1	2.3
Royalties	(1.6)	0.1
Pipe costs	7.4	0.6
Obsolete & scrap inventory	10.2	0.7
Channel costs	5.6	0.4
Total Variance	$ 46.7	4.1

- Product costs were below plan by 2.3 points as a percent of net revenue primarily due to a combination of a shift to higher margin products, an increased mix of licensed product, and CD-ROM media.
  - In comparison to plan, the mix of products sold shifted from Hardware (10% of actual units vs. 12% of planned units) and Internet Platforms and Tools (4% vs. 5%) to higher margin Desktop and Business system products (36% vs. 27%). High margin products include Windows NT Server and NT Workstation and Office.
  - Licenses for Select and MOLP, as a percent of total finished goods, were 46% for the quarter compared to a plan mix of 33% (based on units, not revenue).
  - CD-ROM media was 83% of the packaged product revenue in the quarter compared to a planned level of 61%.
- Total pipe costs were less than plan by $7.4 million or 0.6 points of net revenue primarily due to below plan headcount.
- Total obsolete and scrapped inventory costs were better than plan by $10.2 million (0.7 points of net revenue) due to lower than planned obsolescence charges.
- Total channel costs were less than plan by $5.6 million (0.4% of net revenue) due to below plan freight and fulfillment costs.
  - Freight costs were $2.6 million below plan primarily due to lower packaged product units worldwide.
  - Fulfillment costs were $2.9 million favorable to plan due to lower than anticipated costs associated with several sales programs.

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COST OF REVENUE BY BUSINESS STREAM

Q97-2 FINISHED GOODS AND OEM GROSS MARGIN ANALYSIS

(In Millions)

	Channel FPP		Licensing		Programs		Total FG & OEM
	Software	Hardware	OEM	Retail	Subscriptions	Fulfillment	
Actual							
Net revenue	1,065.7	127.4	$955.3	$901.1	$36.8	$62.3	$3,148.6
Cost of revenue							
Product costs	83.7	60.6	0.2	(1.2)	11.3	16.1	170.7
Royalties	20.2	0.7	3.3	5.2	0.8	0.6	30.8
Pipe costs	9.0	3.7	2.8	7.9	1.8	2.1	27.3
Obsolete & scrapped inventory	15.4	3.7	0.0	0.0	0.0	1.2	20.3
Channel costs	7.3	1.3	0.4	0.7	3.8	9.0	22.5
Total cost of revenue	135.6	70.0	6.7	12.6	17.7	29.0	271.6
Gross margin	$930.1	$57.4	$948.6	$888.5	$19.1	$33.3	$2,877.0
Cost of revenue %	12.7%	54.9%	0.7%	1.4%	48.1%	46.5%	8.6%
Variance from Budget - Fav (Unfav)							
Net revenue	$27.8	($10.8)	$335.0	$262.3	$6.8	$3.3	$624.4
Cost of revenue							
Product costs	14.9	9.2	(0.2)	6.5	(6.8)	(1.3)	22.3
Royalties	(1.0)	0.0	0.2	(0.3)	0.2	(0.2)	(1.1)
Pipe costs	6.3	0.6	1.0	(0.3)	0.4	0.8	8.8
Obsolete & scrapped inventory	10.5	(0.4)	0.0	0.0	0.0	0.3	10.4
Channel costs	1.7	0.0	(0.3)	0.0	1.0	2.7	5.1
Total cost of revenue	32.4	9.4	0.7	5.9	(5.2)	2.3	45.5
Gross margin	$60.2	($1.4)	$335.7	$268.2	$1.6	$5.6	$669.9
Cost of revenue %	3.5%	2.5%	0.5%	1.5%	-6.6%	6.4%	3.9%

- Depiction of costs of revenue by business stream reflects MS' changing business model from manufacturing packaged product to licensing and subscription programs. The reporting and analysis of this view is being incorporated into the monthly and quarterly reporting cycle in FY97. See Appendix for business stream definitions.
- Software package product cost of revenues were lower than the plan by $32 million or 3.5% of net revenue. The favorable variance in product costs resulted primarily from a shift in product mix to higher margin Desktop and Business System products from lower margin Hardware and Internet Platform and Tools products. In addition, the mix of CD-ROM media product exceeded plan by 22% points. Pipe costs were below plan due to lower than plan headcount. Obsolete and scrapped inventory was below plan due to lower obsolescence write-offs.
- Hardware cost of revenues were under plan by $9 million or 2.5% of net hardware revenue due to below plan product costs. This favorable variance resulted primarily from a lower mix of keyboard and gaming device sales and a higher mix of higher margin mouse.
- Retail Licensing costs of revenues were below plan $6 million primarily due to lower costs associated with the Select CDs. This reduction is due to the shipping of language specific updates rather than shipping all languages with each update as assumed in the plan.
- Subscription costs were $5 million higher than plan due primarily to increased MSDN sales driving additional product costs. In addition, the plan for quarterly updates assumed an average of 40 CDs per update and actuals have been averaging 80 CDs per update.

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KEY PERFORMANCE METRICS

(See Appendix for Operations metric definitions)

DISTRIBUTED OPERATIONS (CHANNEL PACKAGED PRODUCT)

	North America			Europe			Far East **			ICON			Total Channel FPP		
	Q97-1	Q97-2	Goal	Q97-1	Q97-2	Goal	Q97-1	Q97-2	Goal	Q97-1	Q97-2	Goal	Q97-1	Q97-2	Goal
Lead Time (days)	7	10	7	12	13	10	24	21	14	17	18	15	12	12	10
Fill Rate %***	81%	79%	95%	83%	69%	80%	37%	48%	65%	57%	61%	65%	77%	70%	81%
Inventory Turns	2.0	3.1	12.0	2.6	7.0	8.0	7.2	8.0	6.5	3.3	3.5	8.0	2.7	4.3	9.5
$ Obsolete & Scrapped Inventory*	$ 9.2	$ 7.8	$ 36	$ 3.8	$ 6.6	$ 20	$ 0.2	$ 2.2	$ 8.5	$ 2.0	$ 2.5	$ 9.0	$ 15.2	$ 19.1	$ 73.5
% of Net Revenues	1.1%	0.9%	1.1%	0.8%	0.9%	0.9%	0.7%	0.8%	0.8%	1.3%	1.3%	1.2%	1.0%	0.9%	1.2%

* Obsolete & Scrapped Inventory goals are annual.
** Far East lead time and fill rate metrics for English Int'l and Chinese products only
*** Fill rate metric for Europe, ICON and Far East regions is based on an order receipt to ship time of 10 days. North America metric is based on 5 days.

- Lead time overall for the quarter was consistent with prior quarter, however there were significant variances in some regions. North America lead time increased by 3 days primarily due to prior quarter backlog and a planned delay in the Office 97 production. Europe lead time increased 1 day due to late lead time decreased by 3 days due to increased focus on backorder and improved supplier performance. The shortfall to goal was largely driven by software and artwork delays
- Fill rates are affected by the same factors as those driving lead times.
- Inventory turns improved in Q97-2 from Q97-1 due to improved inventory management, sales and scrapping of obsolete inventory.

LICENSING OPERATIONS (OEM & SELECT)

Worldwide Licensing Operations		Q1	Q2	Goal
Operating Expense as a % of revenue	OEM	0.12%	0.18%	0.275%
	Select	0.73%	0.76%	1.05%
Transactions per HC per month	OEM	121	143	128
	Select	93	114	128
Processing cost per transaction	OEM	$43.63	$44.28	$51.41
	Select	$41.33	$53.27	$38.68
AR % Current	OEM	76%	84%	80%
	Select	64%	69%	80%
Contract Cycle Time (Ops Center Processing)	OEM	1.5	1.0	2
	Select	4.7	3.7	2
Order Cycle Time (Ops Center Processing)	OEM	8.0	7.0	5
	Select	8.2	6.8	5

- Operating expense as a percent of revenue continues to be better than goal due to cost reductions resulting from the change to shipping language specific product updates Select LARs and licensees. In addition, the change to a rolling 45 day incremental update from a bi-annual update reduced CD expense.
- Transactions processed per headcount per month increased from Q97-1 as Select 2.0 agreements expire and operating processes continue to be refined.
- Processing cost per transaction increased from Q97-1 and is unfavorable to goal due to high temporary labor utilized during the quarter. Year to date, processing cost has decreased 22% to $48.09 from FY96 levels.
- Contract and Cycle time both show improvements in Q97-2 versus Q97-1 due to continued focus on process improvements in the Operations Center.

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PLATFORMS & APPLICATIONS

Q97-2 P&L SUMMARY

(In millions, variance to plan)	Desktop Apps		Desktop Sys		Business Sys		IPTD		Consumer Plat		Softimage		Total Group	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net Revenue	$1,260.4	14.8%	$1,077.1	29.9%	$304.2	18.7%	$118.0	(11.5%)	$0.6	-	$9.8	18.6%	$2,881.6	19.2%
Cost of Revenue	78.6	22.7%	26.6	20.7%	27.4	22.4%	31.0	1.5%	0.0	-	0.6	31.7%	164.2	19.2%
Gross Margin	1,181.8	18.6%	1,050.5	32.1%	366.8	23.8%	87.1	(14.6%)	0.6	-	9.2	24.1%	2,697.4	22.7%
% of Net Revenue	*94%*		*98%*		*93%*		*74%*		*100%*		*94%*		*94%*	
Operating Expenses														
People	33.2	10.8%	5.2	18.2%	51.1	4.0%	49.3	0.4%	5.5	14.0%	3.2	13.4%	152.7	7.1%
Infrastructure	11.6	19.2%	1.8	14.2%	19.9	5.7%	16.9	3.9%	1.8	18.2%	1.6	16.5%	58.5	10.5%
Contingent Staff	5.9	14.0%	3.1	(113.0%)	12.8	(0.5%)	12.7	(58.4%)	1.8	(47.2%)	0.1	26.7%	36.8	(16.1%)
Product Development	14.8	23.9%	3.7	(251.5%)	13.3	6.7%	9.7	32.9%	(0.1)	110.7%	1.5	(6.6%)	43.6	22.0%
Domestic Product Marketing	21.7	5.7%	10.3	(37.9%)	9.8	7.0%	19.0	24.1%	1.0	34.7%	1.5	14.5%	63.2	8.7%
Other	0.1	nm	(0.2)	nm	0.5	(310.9%)	0.5	24.2%	(0.4)	7300.0%	(0.1)	1500.0%	0.5	48.1%
Direct Controllable Operating Exp.	87.3	13.8%	23.6	(30.3%)	107.3	4.1%	108.1	6.2%	9.5	24.8%	8.1	12.2%	354.3	8.3%
Channel/International Marketing	76.8	4.5%	38.5	1.8%	16.5	17.9%	13.8	8.7%	1.4	(37.4%)	0.9	(48.7%)	148.2	5.8%
Taxes, Insurance & Settlement	4.3	(5.1%)	14.7	(26.8%)	1.2	(8.8%)	0.4	(8.8%)	0.0	-	0.0	100.0%	20.6	(20.1%)
Product Support Services	31.7	22.9%	19.2	28.8%	14.4	(4.8%)	15.3	(8.7%)	0.0	87.1%	0.0	-	80.6	15.4%
Bad Debt Expense	13.1	(46.0%)	7.0	(48.7%)	3.4	(52.4%)	1.4	(44.0%)	0.0	-	0.2	(274.0%)	25.3	(48.0%)
R&D Shared Resources	10.7	30.1%	19.2	18.5%	(13.8)	(4.2%)	(3.0)	-	0.7	43.9%	0.0	-	4.9	33.9%
Total Operating Expenses	224.0	10.8%	172.2	1.2%	128.9	4.2%	136.0	6.4%	11.6	22.4%	9.1	7.1%	631.8	6.8%
Responsibility Margin	957.8	28.5%	930.3	38.1%	238.0	(46.8%)	(48.9)	(12.9%)	(11.0)	28.1%	0.1	103.8%	2,066.6	35.9%
% of Net Revenue	*76%*		*86%*		*60%*		*(41%)*		*nm*		*1%*		*72%*	
Corporate Allocations	117.8	5.6%	60.1	4.7%	48.1	7.7%	39.8	7.0%	1.7	14.2%	5.1	10.3%	272.7	6.2%
Contribution Margin	$839.9	35.4%	$870.2	42.5%	$189.9	(72.2%)	($88.7)	(3.0%)	($12.7)	24.7%	($5.0)	37.9%	$1,792.9	45.9%
% of Net Revenue	*67%*		*81%*		*48%*		*(75%)*		*nm*		*(51%)*		*63%*	
Average Headcount	1,554	7.3%	208	11.8%	2,018	2.0%	1,840	5.0%	214	4.9%	169	6.6%	6,263	5.5%
People cost per head	85,501	3.9%	100,291	7.4%	101,407	2.0%	107,113	(4.9%)	101,981	9.8%	75,669	5.2%	98,189	1.7%
Infrastructure cost per head	29,846	12.8%	30,252	2.9%	39,548	3.8%	36,746	(1.2%)	33,569	14.0%	41,917	6.6%	36,073	6.3%

FY97 YTD P&L SUMMARY

(In millions, variance to plan)	Desktop Apps		Desktop Sys		Business Sys.		IPTD		Consumer Plat.		Softimage		Total Group	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net Revenue	$2,239.1	(1.0%)	$1,911.8	30.3%	$732.0	(8.6%)	$248.1	8.2%	$1.1	-	$18.3	17.3%	$5,152.8	7.8%
Cost of Revenue	150.1	25.0%	54.0	14.1%	54.6	23.3%	54.7	5.8%	0.0	-	1.1	34.8%	314.4	20.3%
Gross Margin	2,089.1	1.3%	1,857.8	32.2%	677.5	(7.2%)	193.4	10.2%	1.1	-	17.3	23.4%	4,838.5	10.3%
% of Net Revenue	*93%*		*97%*		*93%*		*78%*		*100%*		*94%*		*94%*	
Operating Expenses														
People	67.0	11.8%	10.0	19.5%	98.4	5.4%	93.6	3.9%	10.7	13.9%	6.5	14.8%	298.3	8.9%
Infrastructure	22.5	20.2%	2.9	15.4%	36.6	9.3%	31.4	9.8%	3.8	11.0%	3.7	12.4%	106.6	13.1%
Contingent Staff	11.3	12.4%	4.6	(57.6%)	24.6	5.0%	21.2	(28.0%)	3.2	(30.4%)	0.3	19.1%	66.4	(4.3%)
Product Development	22.1	45.1%	4.5	(15.3%)	28.4	19.1%	16.4	42.5%	0.9	61.0%	2.6	8.3%	78.1	38.8%
Domestic Product Marketing	35.6	10.1%	15.1	1.1%	15.4	20.9%	32.8	62.8%	1.3	45.1%	2.7	11.5%	102.9	20.0%
Other	0.2	nm	(0.4)	nm	1.2	(419.5%)	1.0	44.0%	(0.4)	nm	0.1	(654.5%)	2.1	8.9%
Direct Controllable Operating Exp.	158.6	19.5%	38.7	3.4%	204.7	9.1%	196.2	13.8%	19.5	18.1%	15.9	12.4%	652.5	14.7%
Channel/International Marketing	125.7	16.4%	58.3	14.5%	29.9	22.2%	22.6	17.0%	1.5	9.2%	1.1	5.2%	239.4	17.0%
Tax, Insurance & Settlement	8.5	(14.1%)	26.0	(24.9%)	2.2	(12.1%)	0.6	(6.8%)	0.0	-	0.0	75.0%	37.4	(21.1%)
Product Support Services	63.0	24.7%	48.2	9.3%	28.7	11.1%	25.5	12.4%	0.1	82.1%	0.0	-	165.4	16.8%
Bad Debt Expense	19.8	(23.9%)	12.2	(43.8%)	5.6	(41.8%)	2.2	(27.5%)	0.0	-	0.3	(171.3%)	40.3	(32.3%)
R&D Shared Resources	19.1	38.3%	38.7	16.6%	(28.9)	(8.6%)	(5.9)	4546.6%	1.3	41.5%	0.0	-	7.7	44.3%
Total Operating Expenses	394.6	18.5%	220.1	6.3%	244.2	10.3%	241.3	15.8%	22.3	19.7%	17.3	11.0%	1,142.8	13.9%
Responsibility Margin	1,694.5	7.4%	1,637.5	40.0%	433.3	5.3%	(47.8)	56.8%	(21.2)	23.7%	(0.0)	99.3%	3,695.7	20.8%
% of Net Revenue	*76%*		*86%*		*59%*		*(19%)*		*(1902%)*		*(0%)*		*72%*	
Corporate Allocations	233.4	7.7%	104.7	17.9%	91.4	11.9%	75.1	11.7%	3.3	15.2%	10.5	8.6%	518.6	11.3%
Contribution Margin	$1,461.1	10.3%	$1,532.8	47.1%	$341.9	3.4%	($123.0)	37.3%	($24.5)	22.8%	($10.5)	37.7%	$3,177.1	28.4%
% of Net Revenue	*65%*		*80%*		*47%*		*(50%)*		*(2190%)*		*(58%)*		*62%*	
Average Headcount	1,548	7.2%	199	11.4%	1,987	1.2%	1,840	3.6%	204	6.8%	170	7.9%	6,101	4.7%
People cost per head	86,518	4.9%	100,583	9.2%	100,068	4.2%	101,756	0.4%	104,873	7.9%	78,500	7.5%	96,385	4.4%
Infrastructure cost per head	29,104	14.0%	29,278	4.6%	37,241	8.1%	34,086	6.5%	36,780	4.4%	43,274	4.9%	34,461	8.8%

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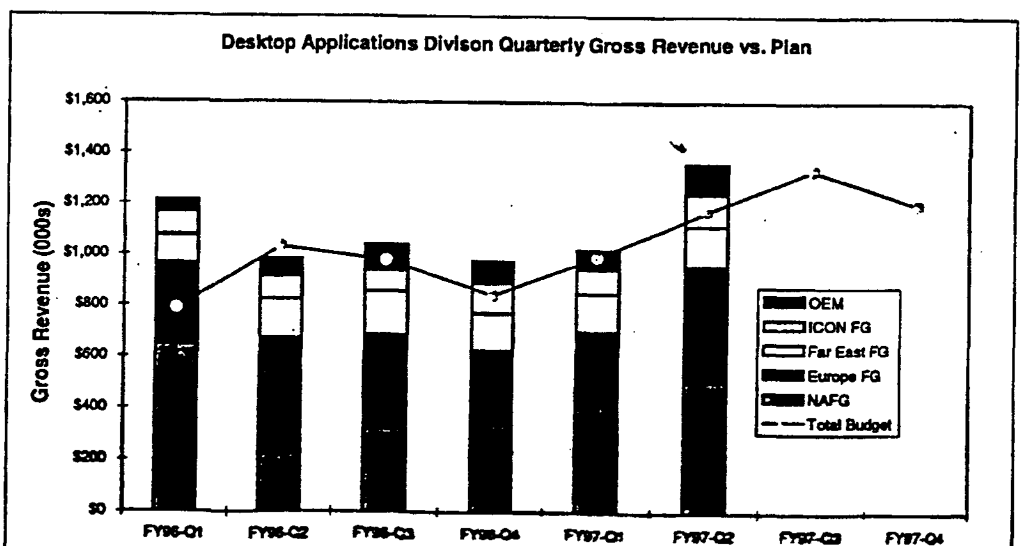
BUSINESS RESULTS

- The Desktop Applications Division (DAD) achieved its largest sales quarter ever with Q97-2 net revenue totaling $1.26 billion, 15% ($162 million) over budget and 29% greater than Q97-1. The positive results were driven primarily by stronger then planned Select revenues, particularly in Europe and the US, and OEM sales. A contributing factor was the initial Office 97 English packaged product sell-in of $107 million.
- Desktop Systems net revenue for the quarter of $1.1 billion reflected strong sales across the entire Win 32 product line. Windows 95 gross revenue of $732 million was $148 million (25%) over plan. Windows NT 4.0 adoption momentum continues to be a key factor of the above-plan performance, with quarterly NT Workstation revenues at $161 million, $58 million (57%) over plan. NT Workstation revenues grew $117 million (268%), over Q96-2.
- NT Server continued to drive above-plan Business Systems performance in Q97-2, with revenues of $166 million, almost $50 million (42%) ahead of plan. New NT Server license shipments approached 220,000 in Q97-2, a 103% increase over Q96-2 shipments.
- Internet Platforms and Tools Division (IPTD) net revenue was 12% lower than plan due to the slip in the release and planned sell-in of Version 5.0 developer tools. This was partially offset by strong sales of Visual J++ (28% over plan) and MSDN. The Microsoft Developer Network (MSDN) product has been very strong at 44% higher than Q97-2 plan and 121% higher than prior year.
- Cost of revenue, as a percent of net revenues, was 3.1 percentage points lower than plan primarily due to a higher license and CD-ROM media mix. See the Operations section for a more detailed discussion of costs of revenue.
- Controllable Platforms and Applications operating expenses were 8% lower than plan for the quarter due to lower headcount and slower than planned spending of marketing, localization and offsite development expenses. Contingent staff expenses were over plan mainly due to shipment delays in Development Tools.

OUTLOOK

- Office 97 sell-in was budgeted in January, but actually began during December. This helped boost Q97-2 results, and may put some pressure on achieving Q97-3 plan. However, with a strong uptick expected worldwide due to the launch and continued strong Select billings, DAD is on track to hit $5 billion in FY97 gross revenues (see chart below).



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- Desktop Systems and Business Systems revenue is expected to continue its growth trend as localized product versions continue to release over the next quarter. Continued acceleration of Windows NT Workstation adoption in the OEM channels will slowly ratchet up revenue/license over the next six months. Expected increases in server application shipments will help sustain momentum, particularly as SQL Server becomes more widely accepted and as Exchange moves from the corporate evaluation stage to deployment. Lockheed Martin and the Department of Defense are two key customers who are moving from the evaluation stage to deployment.
- The Internet Platforms and Tools Division plans to release several strategic product offerings during the remainder of FY97. Version 5.0 developer tools (Visual Basic, Visual C++, Visual InterDev) will be released concurrently in March 1997 emphasizing common interface technologies for internet/intranet development.
- Internet Explorer 4.0, expected to ship in Q98-1, will shift the Internet browser paradigm through better integration with Windows Explorer and support of push technology bringing web information directly to the desktop, enabling Microsoft's vision of the Active Desktop.

DESKTOP APPLICATIONS REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

Microsoft Office 97

- Office 97 Standard and Professional English/International English versions were released to manufacturing in November. Packaged product began selling-in to the sales channel in December and English versions were included on December's Select CD shipments. Additionally, English versions of individual Office applications have been released to manufacturing with street availability of mid-February.
- The official Office 97 US street date was January 16th, with a major marketing blitz following a New York City launch event. The launch campaign will include a 22-city North America roadshow targeted at IT professionals and power users, special retail promotions and displays, a direct mail campaign to approximately 2.8 million registered users, and advertising in publications, including the Wall Street Journal, USA Today, and PC and IS trade magazines.
- German, French, Spanish, and Italian versions of Office 97 RTM'd in December, and will be generally available in January. The Japanese RTM is scheduled for January 31st.
- Office 97 was awarded "Best of the Best" at Comdex held at Las Vegas in November. It also won the Best of Comdex award for Software Applications and was the Editors' pick of Home Office Computing.
- Computer Intelligence's StoreBoard estimates Office unit share in the US *retail* channel, the main battlefield for Corel's $99 suite offering, regained some momentum during the quarter, reaching 53% in November, after September's low of 43%. Microsoft's unit share for suites sold through *all* US channels was 77% in November, with revenue share hitting 87%.
- The first major FrontPage upgrade, Version 97, also began shipping during the quarter reporting strong sell-in results. The Vermeer product unit, with net revenues of $26.3 million through Q97-2, has already totaled 98% of its fiscal year budget.
- Picture It, a new photo imaging product aimed at the consumer market, began shipping during Q97-2. Although sell-in exceeded 100,000 units, sell-through results have been below expectations prompting the estimated retail price to be lowered by $20 to $54.95.
- Publisher 97 and Greetings Workshop both posted revenues well above plan during Q97-2, and sell-through totals for both products were up due to the holiday buying season.
- A major reorganization of the Office group, designed to facilitate Office 9 development, was announced during the quarter. In addition to the creation of cross-application feature teams, the individual application business units were merged with the combined Word and PowerPoint team led by Peter Pathe, and the Excel/Access team managed by Richard McAniff. Cross-application teams created included Total Cost of Ownership, Web Client features, Web Server features, User Interface & Assistance, Programmability, Release, and Base Technology. Also, a new Macintosh Product Unit led by Ben Waldman was created, initially charged with completing the Office 97 Mac version.

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COMPETITION

Corel

- Corel announced a new licensing program in November called Corel Office for Windows NT Server 4.0, which offers simultaneous unlimited suite application usage to all users connected to the server and allows an organization to grow without having to purchase additional licenses.
- The new product will be available to corporate customers through the following three Corel License Program (CLP) purchasing options:
  - Shrink-wrap: Customers can purchase one copy of the software for a suggested retail price (SRP) of $1,995. Once installed, the applications can be accessed from both 16-bit and 32-bit workstations.
  - CLP Choice: Organizations can install product on more than one server and purchase additional licenses through CLP Choice. This license-only program has no minimum purchase restrictions and is available through any Corel Authorized Reseller at $1,595 (SRP).
  - CLP Universal: This option is targeted at larger organizations with at least 25 servers running Windows NT Server 4.0 and is available through any Corel Universal Authorized Reseller. Organizations with more than 25 servers can take advantage of incremental discounts and pay as low as $1,200 per license.
- Corel licensed Borland's Paradox source code in October and assumed responsibility for development, marketing, sales and support of the Paradox family of products worldwide. Under the terms of the license agreement, Borland will continue Borland Database Engine development, a key technology found in Paradox and other Borland products, and will continue to sell stand-alone Paradox versions through October 21, 1997 as a customer service to Borland's corporate customers.
- Corel announced a preview, available for live access from its Web site, of its upcoming Office for Java, a suite including WordPerfect for Java, Quattro Pro for Java and CorelCHART for Java. Corel is promoting the product as the first Java office suite available in the market.
- Corel announced the launch of CorelDRAW 7 at a suggested list price of $695. Designed for Windows 95 and Windows NT 4.0, the three main applications are CorelDRAW, Corel PHOTO-PAINT and CorelDREAM 3D.
- Corel Corporation announced that it has licensed Sanga Pages from Sanga International. The deal will enable Corel to incorporate Java-based groupware functionality into its Office for Java. In addition, Sanga Pages enables Corel Office for Java users to build collaborative applications with the Rapid Application Development (RAD) environment. The deal will also allow Corel to add the functionality to Java-enabled desktops as well as future Windows and Macintosh versions of its desktop productivity applications, including Corel WordPerfect Suite 8 and Corel Office Professional 8.
- Corel Corporation also began shipping Corel WordPerfect for UNIX and VENTURA 7 in the quarter. VENTURA 7 is a desktop publishing package rewritten for Windows 95 and Windows NT 32-bit processing and multi-tasking capabilities.

Lotus (IBM)

- Lotus announced its Approach 97 Internet-enabled desktop database for Windows 95/NT is scheduled to ship during Q97-3.
- Lotus announced the following North American promotions:
  - Corel-to-SmartSuite Trade-UP: Customers who have purchased qualifying Corel products on or before October 96 were eligible to "trade-up" the applications for a free CD upgrade to SmartSuite for Windows 95 or Windows 3.1 through 12/31/96. The offer was made available to anyone who purchased Corel WordPerfect Suite 7 for Windows 95 or Windows 3.1 and Corel Office Professional 7 for Windows 95 or Windows 3.1
  - Cash In with Lotus: All registered customers who purchased SmartSuite 96 between 9/26/96 and 12/31/96 are eligible to receive a $50 mail-in rebate plus a free CD upgrade to SmartSuite 97, the upcoming version of Lotus' business applications suite scheduled for delivery in January 1997. This retail program allows customers to obtain SmartSuite 96 for only $99, a discount from the $149 estimated retail upgrade price.

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DESKTOP & BUSINESS SYSTEMS DIVISION REVIEW

BUSINESS SYSTEMS

INVESTMENTS & PRODUCT HIGHLIGHTS

- BackOffice Version 2.5, featuring the latest component application versions, was released in November 1996. It now also provides secure Internet access to networked computers with the addition of Proxy Server 1.0.
- Internet Information Server (IIS) 3.0 became widely available in December and featured support for Active Server pages, network broadcasting (NetShow) and other enhancements.
- Compaq and Microsoft set a new TPC-C performance record (7,512 tpmC and $77.59/tpmC) for SQL Server running on the Windows NT platform. SQL Server now holds the top seven (and eight out of the top ten) TPC-C price/performance results.
- SNA Server 3.0, featuring improved setup and management features, shipped during Q97-2. The latest release makes it easier for NT Server networks and PC desktops to integrate with IBM mainframe and AS/400 systems.
- Microsoft announced the Advanced Data Connector (ADC) in December, which provides the infrastructure to link SQL server databases on Web servers with ActiveX controls within Internet Explorer.
- Microsoft Transaction Server, formerly known as Viper was released in late December. It is a tool for facilitating transaction processing and object brokering over the network.
- Exchange Server 5.0 beta was shipped to customers with general availability of the final product expected in Q97-3. Version 5.0 extends the product's benefits to include Web-based collaboration and communications features based on the Active platform.
- During the quarter, Microsoft acquired multi-dimensional Online Analytical Processing (OLAP) technology from Panorama Software Systems. The technology will be used to provide a common set of interfaces to enhance future database application products.
- Microsoft Commercial Internet System (MCIS) 1.0, a suite of Internet server products including merchant services, Internet mail, news, and chat capability, released in December.

COMPETITION

- Oracle and Netscape announced an agreement to jointly market and distribute each other's products. This includes making Navigator the only browser offered on Oracle's network computer. Oracle and Sun announced a trial suite of Java-based business applications and development tools on Sun's Netra j server in November.
- Oracle announced beta availability of Web Application Server in December, a component of its network computing platform, featuring distributed transaction processing, interoperability and CORBA compliance.
- Netscape and Sun announced plans to incorporate support for Sun's Internet file system (WebNFS) in Netscape products. In addition, the two companies will ensure interoperability between their Internet connectivity standards.
- Lotus (Domino Merchant), Oracle (Electronic Commerce Solution / Project Apollo), Netscape (Netscape Payment Kit), and Open Market (ActiveCommerce DB) announced entry into the Internet commerce field with bundled solutions including electronic cash, marketing and promotional tracking, catalog shopping, secure transactions, and payment systems
- Netscape is developing Platform Independent Internet Security Solutions in conjunction with over 50 companies.
- IBM plans to introduce encryption technology (PQR) with digitized certified mail for securing transfers of files or messages over the Internet by mid-1997.

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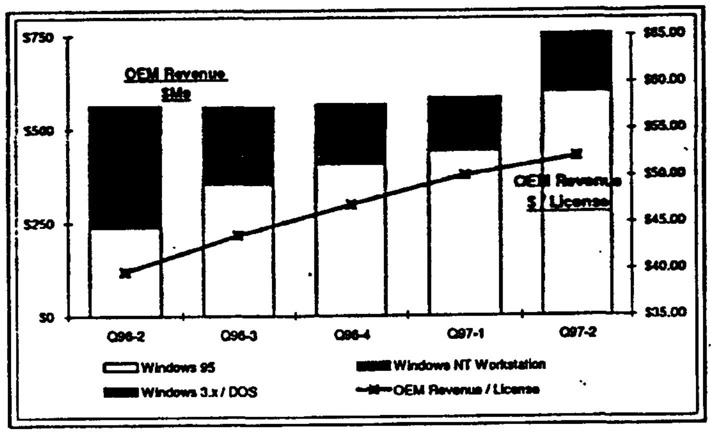
DESKTOP OPERATING SYSTEMS

INVESTMENTS & PRODUCT HIGHLIGHTS

- The European & Far East versions of Windows NT 4.0 Workstation was launched. continuing industry momentum toward the 32-bit Windows family. Two million Windows NT 4.0 Workstation licenses have been shipped worldwide in FY97 and 14% of the Windows NT Workstation installed base has upgraded to version 4.0.
- Windows 95 posted its strongest sales quarter since initial release, driven by increased PC shipments, slight increase in OEM penetration and holiday related sell-in. Windows 95 life-to-date sell-through is estimated to be about 56 million licenses. Worldwide, Windows 95 was sold throughout the quarter at a rate of more than 1 copy *every second.*
- The retail bundle of Windows 95 and Internet Explorer 3.0 has replaced unbundled Windows 95 in the US retail channels. Localized European bundle versions were shipped in October.
- Desktop Operating Systems OEM revenue per PC continues to rise as product mix continues to shift from Windows 3.x to Windows 95 and Windows NT Workstation. (See chart Below)



COMPETITION

- Apple Computer agreed to purchase NeXT for $400 million. Pending regulatory approvals, all NeXT products, services, and technology research will become part of Apple. Apple also announced a new operating system, called Rhapsody, which will be based on the NextStep operating system and released in mid-to-late 1997. Rhapsody initially will not run any existing Macintosh applications, limiting Apple's expectations for user migration until mid-1998, when the "unified" Rhapsody release will run Mac software in a separate window at current PowerPC systems speed.
- Apple Computer announced a beta release of Mac OS Runtime for Java, an implementation of Sun's Java virtual machine (VM) and run-time environment, enabling developers of Mac OS-based applications to create Java applets and standalone Java applications.
- IBM announced availability of the Netscape Navigator browser for OS/2 Warp 4. The new version allows Netscape Navigator users to surf the Internet with simple voice commands for the first time in a shipping product. With support for OS/2 Warp's VoiceType speech recognition, users can tell their computer to "jump" to a site on the Internet and subsequently move around within that site by saying the names of links or commands such as "page up," "scroll down," or "back."

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INTERNET PLATFORMS & TOOLS DIVISION REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

- Version 5.0 of MS's flagship developer tools. Visual Basic, Visual C++ and Visual InterDev. a product that enables development of interactive database-driven Web applications in an integrated visual environment, are on track to be RTMed in February and available in the channel in March.
- Internet Explorer (IE) 3.0 for Win 3.1 was released in December with the Mac version shipping in January 1997. More than 6 million users have downloaded IE since August. boosting IE market share (based on call-down data) to 12% at quarter's end, up from 8% in September. IE browser share based upon hits to popular web sites has also improved. Call-down browser share data is lower than web-hit share data because call-downs include America On-Line (AOL) browser users. AOL caches web pages on their web server.

Recent browser share data is as follows:

Internet Browser Share based on Call-downs by Market Decisions	As of June '96	As of Sept '96	As of Dec '96
Microsoft Internet Explorer	6%	8%	12%
Netscape Navigator	52%	51%	55%

Sampling sizes: June=271, September=118. and December=250 users.

Internet Browser Share based on Univ. of Illinois EWS site hits	As of June '96	As of Sept '96	As of Dec '96
Microsoft Internet Explorer	11%	16%	21%
Netscape Navigator	82%	79%	75%

Internet Browser Share based on Interse.com site hits	As of June '96	As of Sept '96	As of Dec '96
Microsoft Internet Explorer	8%	39%	33%
Netscape Navigator	78%	52%	54%

Internet Browser Share based on Browserwatch.com site hits	As of June '96	As of Sept '96	As of Dec '96
Microsoft Internet Explorer	12%	19%	39%
Netscape Navigator	78%	64%	49%

Internet Browser Share based on CNET site hits	As of June '96	As of Sept '96	As of Dec '96
Microsoft Internet Explorer	21%	34%	34%
Netscape Navigator	65%	59%	58%

- Major enterprises are beginning to deploy IE as their standard browser. Organizations such as Arthur Andersen, Sprint Spectrum, Compaq, U.S. Navy, and Coopers & Lybrand choose IE due to better integration with existing systems, greater security and customization, and broader internet and intranet functionality.
- PC Computing Magazine named IE 3.0 Best Web Browser while awarding Visual Basic 4.0 the Application Development Most Valuable Player award.
- An agreement was announced with Pointcast where Pointcast will become a premier content provider of customized Web information that will be provided directly to the user's desktop as part of IE 4.0 and the Active Desktop. Pointcast has selected Internet Explorer as their standard browser. MSNBC also agreed to be a key news and information provider to the Active Desktop, and plans to offer its original content.
- US Web, one of the nation's largest professional web services firms, announced it will use IE 4.0 and the Active Desktop as its strategic Internet and Intranet technology platform.
- An updated Internet mail and news feature for IE 3.0 for Win 95, the first to use the Lightweight Directory Access Protocol (LDAP) was released in the quarter. LDAP enables email name searches of Internet white pages in conjunction with four leading Internet white pages providers, Bigfoot, Four11 Corporation, WhoWhere?, and Switchboard.
- Also released in the quarter was the IE Starter Kit (IESK) with IE 3.0 for Win 95. IESK includes the Personal Web Server, ActiveX Gallery, Internet Connection Wizard (enables connecting to pre-defined local Internet Service Providers), and a trial version of Hellbender. IESK is available in retail stores at a suggested retail price of $24.95.
- Other product releases included the IE Administration Kit (IEAK) version 3.1, online gallery of Java class libraries and software development kits for Java and ActiveX controls for MacOS. IEAK allows corporate administrators to pre-configure and manage browser distribution for clients on the Win 3.1 and Win 95 platforms.

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Competition

- Netscape released its Communicator client beta to key development partners ahead of schedule. Communicator includes enhanced email and internet-searching directory features. They also were the first to release a beta version of a browser which supports Java on the Win 3.1 platform.
- Netscape discussed a future product called Constellation at Fall Comdex. It represents an electronic workspace accessible from any PC running the Constellation software, which incorporates push broadcast technology, downloading web pages directly to the desktop. Constellation is expected to compete with the IE 4 Active Desktop.
- Netscape announced In-Box Direct for Suitespot, which allows enterprises to deliver web pages and tailored news directly to employee in-boxes.
- IBM/Lotus announced Weblicator, a $29 client product which performs limited Lotus Notes functions on any Internet browser. It allows users to download Web-based information when connected to a Domino server, manipulate it off-line, and synchronize the information when reconnected to the server.
- Symantec announced Visual Café Pro for Windows, the first rapid application development (RAD) tool for developing applets capable of connecting to relational databases. Asymetrix also announced a RAD Java product called SuperCede, which leverages C++ code investments and ActiveX technology by building a bridge between this existing code and Java.
- Borland previewed its Borland C++ Builder product, planned for Q97-3 release. The product is perceived to have good compilers and reusable code as part of a trio of visual tools. Borland also announced the Open JBuilder Partner Program, an effort intended to support development partners by delivering beta versions and other product support.
- Sun Microsystems will host an International Standards Organization meeting in January to discuss evaluation of Java as an industry standard. If approved, the effort is expected to broaden the adoption of Java technology.

SOFTIMAGE

Investments & Product Highlights

- Softimage 3D Version 3.7 for NT and Irix shipped to beta sites in December with a service pack of 3D Version 3.5 shipping to maintenance customers at the same time. Version 3.7 includes new viewing and lighting features as well as support for TrueType fonts and enhanced tools for the Sony and Sega game platforms. This version is positioned as a stepping stone to Sumatra, the next generation of Softimage 3D, expected in Q98-3. Also, a new version of the Softimage Software Development Kit (v1.7) is included in this beta.
- Digital Studio, scheduled to be released in January, has slipped, with a beta release now expected in February. The primary reason for the delay is Matrox hardware instability. Alpha tests have been conducted with a select group of users and results are being incorporated into the beta release. Also, Sony is evaluating an OEM relationship for Digital Studio.
- Softimage 3D Version 3.7 and the Sumatra prototype were demonstrated to leading customers in Europe, Canada and the U.S. in a December briefing tour. The primary goal was to counter SGI/Alias's Maya product momentum and to generate excitement for upcoming product releases. Customer feedback was extremely positive and several large deals were concluded as a result of this briefing.
- Plans for a new product called Twister have been completed, with shipment scheduled for Q98-1. Twister will be based on the Sumatra architecture and will provide a universal rendering solution, targeted at Pixar's Renderman installed base. The product will include new Mental Ray v2.0 technology, support for many 3D and CAD packages, and a renderfarm control framework.

Competition

- SGI/Alias's next-generation product Maya hit many snags during its alpha tests with leading customers. As a result of these problems, several customers, including Disney, Dreamworks, and Sony, have switched to Softimage 3D for upcoming computer graphics productions. Maya was scheduled to ship in March, but will probably slip due to these problems.

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- NewTek's Lightwave 3D is winning mid-range sales at the expense of Kinetix/Autodesk's 3D Studio MAX and is becoming a real threat in the games market. Like Softimage 3D, Lightwave runs on the SGI and NT platforms, as well as the Amiga and Sun platforms. Lightwave sells for $999 versus Softimage 3D's price of $7,995.
- Discreet Logic is working on an NT version of Flint, its successful compositing and effects product, and is planning to demonstrate it at the NAB spring tradeshow on an Integraph platform. Avid is working on a Digital Studio-like product and may show it at NAB as well.

CONSUMER PLATFORMS

INVESTMENTS & PRODUCT HIGHLIGHTS

- Microsoft launched the Handheld PC (HPC) at Fall Comdex with its seven OEM partners - Casio, Compaq, Hewlett-Packard, Hitachi, LG Electronics, NEC and Philips Electronics. The HPC is the inaugural product based on Windows CE, a new open, scalable Windows operating system platform designed for a broad range of communications, entertainment and mobile computing devices. Microsoft also announced that more than 90 independent software and hardware vendors plan to have Windows CE-based commercial applications, hardware peripherals and communications solutions available by the end of the calendar first quarter of 1997. HPC's from Casio, Compaq, and NEC are currently available in the retail channel for $500-$700 depending on hardware options.
- Microsoft announced it is working with Intel to port the Windows CE operating system to the Intel Architecture, increasing the number of microprocessor families supported by Windows CE to five. The other supported processors are the SH-3 processor from Hitachi; MIPS-based processors from NEC and Philips Semiconductors; Advanced RISC Machine (ARM)-based processors and PowerPC processors.
- Microsoft announced an agreement with Derwent Information, the industry leader in international patent information, to develop international patent database solutions based on the Windows NT operating system. These solutions will focus on making global patent information easier to access, use, and share, and leverages Microsoft's existing patent database of more than 5 million documents.

COMPETITION

- Apple recently announced the fourth version of its Newton device. The two new models are the $800 eMate 300 (aimed at the K-12 education market) and the $1000 Message Pad 2000 aimed at the white-collar workforce.
- Sharp launched its new pocket-sized Zaurus, ZR-3000, which offers PC synchronization software, Microsoft-compatible word processing and spreadsheet, personal information management software, and email for $399 + $139 for the connectivity software and cables.
- Sony and Philips began selling set top box devices that allow Internet browsing on regular TV screens. The box retails for approximately $330 and requires Internet service through WebTV, which costs an additional $20 per month. The service provides email accounts for up to 6 family members. An additional wireless keyboard can be purchased for approximately $80.

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INTERACTIVE MEDIA GROUP

Q97-2 P&L SUMMARY

(in millions, variance to plan)	Consumer SW & IMS		MSN		Hardware		Desktop Finance		Total IMG	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net Revenue	$131.0	0.6%	$21.8	(68.6%)	$128.8	(7.4%)	$10.8	30.1%	$296.4	(10.2%)
Cost of Revenue	36.9	8.9%	50.0	(33.4%)	65.3	9.4%	2.7	10.2%	158.1	-
Gross Margin	94.1	4.8%	(28.3)	(274.5%)	61.5	(5.1%)	8.0	53.7%	138.3	-
% of Net Revenue	72%		(130%)		48%		75%		47%	
Operating Expenses										
People	22.5	29.6%	11.5	(3.4%)	3.7	(18.1%)	2.8	19.1%	47.3	17.7%
Infrastructure	10.3	32.7%	4.0	2.0%	1.5	13.7%	0.7	26.0%	18.4	23.5%
Contingent Staff	11.9	17.1%	5.3	(57.1%)	3.3	(49.3%)	0.4	(10.9%)	21.5	(3.8%)
Product Development	8.0	88.2%	21.9	(4.5%)	3.8	23.9%	0.4	73.0%	34.8	36.1%
Domestic Product Marketing	12.0	(97.3%)	15.7	36.6%	2.1	36.9%	1.8	15.8%	31.7	13.0%
Other	0.5	22.4%	1.0	(28.0%)	0.4	-	0.0	95.6%	30.3	11.4%
Direct Controllable Operating Expense	65.1	30.3%	59.4	8.7%	14.8	4.7%	6.2	27.3%	183.9	19.1%
Channel/International Marketing	9.9	15.3%	3.6	25.9%	3.1	30.7%	0.5	45.2%	17.1	21.4%
Tax, Insurance & Settlement	0.6	(20.7%)	0.9	21.9%	1.0	(21.6%)	0.0	(4.8%)	2.5	(1.1%)
Product Support Services	2.8	15.3%	22.0	(73.0%)	0.9	(28.8%)	0.6	(72.5%)	26.4	(53.4%)
Bad Debt Expense	1.1	(66.6%)	3.5	(48.9%)	0.8	(18.0%)	0.1	(65.1%)	5.4	(45.0%)
R&D Shared Resources	0.2	75.1%	1.4	38.6%	0.6	26.6%	0.3	31.4%	(5.1)	33.9%
Total Operating Expenses	79.7	27.6%	90.7	(2.7%)	21.1	7.9%	7.7	25.2%	230.3	13.0%
Responsibility Margin	14.4	170.1%	(118.9)	(65.0%)	40.3	(3.5%)	0.4	107.2%	(91.0)	(1.8%)
% of Net Revenue	11%	-	(548%)	-	32%	-	3%	-	(31%)	-
Corporate Allocations	21.4	13.3%	8.4	13.0%	8.0	7.3%	2.7	16.4%	40.6	12.1%
Contribution Margin	(57.0)	84.5%	($127.3)	(55.7%)	$32.3	(2.5%)	($2.3)	71.7%	($131.7)	2.9%
% of Net Revenue	(5%)		(585%)		25%		(22%)		(45%)	
Average Headcount	808	21.7%	361	(9.4%)	115	3.4%	122	6.2%	1,505	12.7%
People cost per head	111,317	10.1%	127,224	5.5%	127,409	(20.1%)	92,680	13.8%	118,500	5.7%
Infrastructure cost per head	50,767	14.1%	44,410	10.4%	51,304	10.7%	23,934	21.1%	46,229	12.3%

FY97 YTD P&L SUMMARY

(in millions, variance to plan)	Consumer SW & IMS		MSN		Hardware		Desktop Finance		Total IMG	
	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %	Actual	Var %
Net Revenue	$181.9	3.2%	$47.6	(48.7%)	$202.4	(4.3%)	$13.3	17.2%	$450.1	(8.5%)
Cost of Revenue	54.4	9.8%	90.0	(25.7%)	107.1	9.3%	4.5	(0.4%)	257.7	-
Gross Margin	127.5	10.0%	(42.4)	(300.2%)	95.2	1.9%	8.9	28.0%	192.4	-
% of Net Revenue	70%		(89%)		47%		66%		43%	
Operating Expenses										
People	43.1	29.8%	19.1	14.1%	7.0	(11.6%)	5.5	18.1%	88.9	20.3%
Infrastructure	19.5	29.7%	6.6	9.8%	2.8	15.9%	1.3	30.0%	34.4	22.3%
Contingent Staff	23.9	12.8%	8.7	(40.5%)	5.8	(29.9%)	0.7	7.6%	41.9	(4.6%)
Product Development	27.8	58.6%	25.4	12.9%	7.0	29.4%	0.9	72.1%	62.0	44.4%
Domestic Product Marketing	11.3	450.3%	25.9	47.7%	2.4	47.1%	2.5	32.9%	42.1	23.1%
Other	0.8	36.8%	1.5	12.5%	1.0	-	0.0	98.2%	64.6	12.9%
Direct Controllable Operating Expense	126.3	30.4%	87.2	24.9%	26.0	8.8%	10.9	34.5%	333.9	23.5%
Channel/International Marketing	15.2	29.5%	6.0	38.3%	5.2	38.0%	0.8	49.0%	27.4	33.7%
Tax, Insurance & Settlement	1.1	(20.5%)	1.0	45.2%	1.7	(15.2%)	0.0	(5.3%)	3.9	10.7%
Product Support Services	5.3	19.1%	39.6	(54.4%)	1.3	4.3%	1.1	(67.0%)	47.5	(37.5%)
Bad Debt Expense	1.6	(37.1%)	5.2	(25.9%)	1.2	(0.7%)	0.1	(48.7%)	8.2	(22.5%)
R&D Shared Resources	2.6	(96.5%)	2.7	37.0%	1.2	27.4%	0.7	30.1%	(7.9)	44.2%
Total Operating Expenses	152.0	28.6%	141.7	12.5%	36.7	14.0%	13.7	31.6%	412.9	18.9%
Responsibility Margin	(24.5)	74.8%	(184.2)	(30.9%)	58.5	15.3%	(4.8)	63.0%	(220.5)	19.1%
% of Net Revenue	(13%)	-	(387%)	-	29%	-	(36%)	-	(49%)	-
Corporate Allocations	41.5	15.1%	16.1	14.8%	15.3	12.6%	5.3	16.9%	78.2	14.6%
Contribution Margin	($66.0)	54.8%	($200.2)	(25.5%)	$43.2	30.0%	($10.1)	48.0%	($298.7)	18.0%
% of Net Revenue	(36%)		(421%)		21%		(76%)		(66%)	
Average Headcount	775	18.0%	311	(6.0%)	111	6.4%	115	7.6%	1,496	11.4%
People cost per head	111,368	14.3%	122,570	18.9%	125,501	(19.3%)	96,211	11.4%	118,789	10.0%
Infrastructure cost per head	50,241	14.2%	42,729	14.9%	50,049	10.1%	22,787	24.2%	45,922	12.2%

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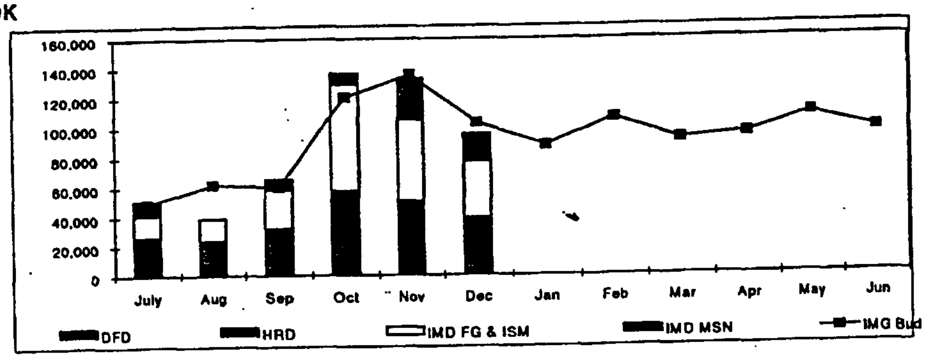
BUSINESS RESULTS

- Net revenue for the recently reorganized Interactive Media Group (IMG) totaled $295 million for Q97-2, 10% below plan. Responsibility margin was a loss of $132 million, 3% better than plan. Revenues were lower due to the billing related-shortfall of MSN and lower keyboard sales and delays in the release of Intellimouse. IMG's Q97-2 responsibility margin benefited from lower overall operating expenses.
- MSN net revenues of $22 million were $32 million below plan primarily due to the forgiveness of additional hours charges ($20 million), lack of billings for the 2nd half of December ($8m) and average paying subscribers for the quarter being under plan by approximately 300 thousand. Responsibility margin for Q97-2 was a loss of $119 million, $47 million (65%) higher than plan driven by lower revenues ($32 million), higher telecom costs ($10 million) and support costs ($9 million) partially offset by lower development costs.
- Total MSN subscribers for the quarter were 1.88 million, versus a planned subscriber count of 2.4 million, of which 1.62 million were paying members and 263 thousand were trial members. The total subscriber count is about 520 thousand below budget primarily in the US due to lower than planned trials in November and December and higher cancellation rates in December when customers saw the effects of the retroactive subscription charges.
- Consumer Software and Interactive Media Services revenues were about even to plan with strong holiday sales of Encarta 97 and Entertainment titles such as Flight Simulator, Deadly Tide and Monster Truck Madness. Responsibility margin was $14 million, $35 million (170%) higher than plan driven by lower product development spending and people expenses. Also contributing was the slower than planned rollout of Sidewalk which resulted in $14 million of lower operating expense for Q97-2.
- Net revenue for Desktop Finance was $11 million, 30% over plan. The strong performance was due to better than expected shipments of Money 97 which was released on September 30. Operating expenses for the quarter were 25% below plan.
- Hardware revenues were $10 million (7%) below plan in Q97-2 due to lower keyboard sales. Lower costs of revenue driven by a greater mix of higher margin mouse sales were offset by higher people expenses resulting in responsibility margin about 4% below plan.

OUTLOOK



- There is a fair amount of downside risk in IMG's second half outlook. A combination of MSN subscriber levels forecasted to be lower than plan, continued MSN billing uncertainties, and channel inventory risk for certain software titles creates downside second half risk. Upside opportunities include better Hardware results from Intellimouse, continued Money 97 momentum and continued favorable expense variances.
- Due to the strong sell-in of a number of consumer software titles, second half revenues contain a modest degree of return risk. Adequate reserves are established for expected returns, but final returns will not be known till the end of Q97-3. The revenue growth of online businesses such as MSN and Sidewalk will, over time, generate a different seasonal trend for IMG. However, at present, Hardware and Software revenues, strongly tied to holiday selling cycles and launch dates, will define IMG's sales pattern.

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INTERACTIVE MEDIA DIVISION

INVESTMENTS & PRODUCT HIGHLIGHTS

MSN

- MSN Version 2.0 was released in October in the US to 100,000 preview members and then to remaining one million paying members in the US in November. A press release event was held on October 10th in Redmond with a subsequent event in New York the following week. Press coverage of both events was very high and positive to the new "TV" look of the MSN. The new MSN version uses channels targeted at specific user interests, demographic profiles and offers a "show" approach, with sequels and episodes.
- MSN's broad reach advertising program began on October 22nd. Other marketing initiatives include direct mailings to existing Win95 customers, a joint distribution program of 1 million CDs including Internet Explorer, inclusion of MSN CD in Office 97 and CD distribution programs with Tower Records and United Artists Theatres.
- During Q97-2 MSN was able to catch-up billings through December 14th versus being two months behind at the beginning of the quarter. In order to become current, MSN had to forgive additional hour charges for June through October as these charges are very processing intensive and have a high risk of error.
- Support costs continued to run significantly over plan. The incident rates for Technical Support calls are very high, partially related to problems with the preview CD and the release CD distributed to about 100,000 members. Customer support costs are also high due to cancellations and inquiries relating to retroactive billing charges.

Interactive Service Media (ISM) Online Services

- Effective January 6, the Information Business Unit was restructured resulting in the new Interactive Service Media (ISM) division with the charge of building a core online system to empower people to make better decisions and take actions that significantly improve their daily lives. Sidewalk will be the umbrella brand for all of ISM's online offerings. This will initially be accomplished by using many of the national properties such as Expedia, Carpoint, Cinemania and Music Central to feed the Sidewalk engines in each city.
- Sidewalk, the on-line city guide to entertainment, was formally announced in November. A total of eleven city GMs have been hired for the Seattle, New York, Minneapolis, San Francisco, San Diego, Washington D.C., Boston, Houston, Denver, Sydney and Montreal markets. Overall, headcount is at 51% of plan due to slower than expected hiring of the local city teams. Sidewalk Seattle is scheduled to launch in the upcoming quarter with New York and Boston following in Q97-4.
- Expedia, the Microsoft branded travel service, was released as scheduled on October 22. The reviews have been overwhelmingly positive. PC Week magazine chose Expedia as the #1 Ecommerce site on the web. Revenue is lower than expected but the trend is positive. There are over 140,000 registered users generating 300-400 thousand visits per day. Northwest Airlines signed a license to private label Expedia and there is an LOI in place with Continental.
- On January 10th, Slate announced that it will remain a free site indefinitely. The magazine's mission is to build a strong brand in the area of opinion journalism on the Internet. With this objective, combined with the rapidly growing Internet, it is better to optimize for the largest number of readers by remaining free. However, at some point, subscription revenues will be important to a sustainable business model. Reader surveys remain very favorable.

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Consumer Software

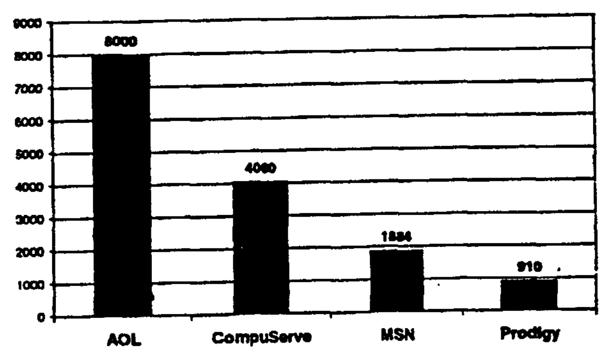
- Strong pre-holiday sales of Entertainment titles into the distribution channel were well coordinated with holiday product releases resulting in robust sales of most titles. Flight Simulator 6.0 (first Windows-based version), released in October, led the group with $35 million worldwide revenues and sold 856,000 units into the channel. Other titles with strong sales include Monster Truck Madness, Deadly Tide, and Golf 3.0. Revenue reserves totaling $10 million were recorded to offset potential returns of some titles in Q97-3.
- Alexey Pajitnov, creator of Tetris, the world's most popular electronic game, joined MS in October to develop mind-teaser and puzzle games for on-line play.
- Five children's titles, Magic School Bus Dinosaurs, Nickelodeon 3D Movie Maker, Creative Writer 2.0, PJs Reading Adventure and Beyond the Limit, were released this quarter. While companies are trying to beat the shelf space problem by selling low priced bundles, the top selling titles continue to be stand alone products that either have proven market appeal or are branded such as Disney and Barbie. Sales volume is shifting from traditional software channels, where Microsoft is strong, to mass market, consumer driven channels such as Price Club, WalMart, where Microsoft is not as strong.
- Japanese Encarta, which was released in the 2nd quarter is a big milestone that should translate to a strategic win for Microsoft. This is the first significant multimedia encyclopedia to hit the Japanese makrket. It is also the first attempt by MS to enter the Far East content market. The Japanese version represented a huge challenge to the Encarta product team because the product used double byte enabled code and represented truly localized content.
- The Geography Unit is developing Internet and intranet mapping server technology that will be used by other Microsoft groups such as Expedia, Sidewalk, Carpoint and MSN, and will also be licensed to third parties.

COMPETITION

MSN

- Including trial subscriptions, MSN increased its subscriber count by 273 thousand or 17% in Q97-2. As the chart at the right depicts, AOL and CompuServe gained 1.2 million and 300 thousand subscribers respectively. Prodigy's subscriber count was down 90,000.
- America Online and Prodigy continue to offer unlimited use for $19.95, but Netcom decided to end unlimited pricing. AOL users are staying connected up to 20% longer and are logging on an additional 2 million times a day since the flat rate, unlimited access service started on December 1.

Online Media Subscribers



ISM Online Services

- In addition to a variety of local operations, there are several national competitors in the on-line city guide market including City Search, Digital City, Yahoo! and AT&T.
- City Search, a privately held company financed by Goldman Sachs, AT&T Ventures and private investors, has established sites in Raleigh-Durham, Pasadena, and New York. They have publicly stated plans to have sites in 30 cities by the end of 1997. Digital City is a $100 million joint venture between AOL and the Tribune Company. They are offering their first services in Boston and Washington with a target of launching in the nation's top 20 to 30 markets in the next year. Yahoo! has active sites in San Francisco and Los Angeles; its sites are very similar to the Yahoo site but the content is intensely local. AT&T's Hometown Network hopes to have 70 sites running by end of 1997. Their strategy is to promote Hometown Network through AT&T's long-distance service and are currently running a trial site in Sacramento, CA.

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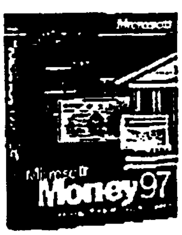
IMD Consumer Software

- Nintendo 64 game console was the hit product of the holiday season, selling 4 million units worldwide, 2.1 million of which was in the US. An additional 2.4 million units are forecasted to be sold worldwide in the first quarter of 1997. Sony announced cumulative sales of its Playstation and related compatible software titles exceeded $1 billion.
- In an alliance with IBM, World Book has recently entered the market with a 2 CD ROM multimedia encyclopedia that may prove to be a strong competition to Encarta. The World Book product is comparable to Encarta in the number of articles, total words and price but appears to be more oriented to younger users.
- Industry consolidation continued with IBM's $80m purchase of Edmark, and CUC's acquisition of privately held Knowledge Adventure. IBM will continue to distribute titles under the Edmark name. CUC believes Knowledge Adventure's popular Jumpstart skills series will complement their education titles and benefit from CUC school and online distribution channels.
- Competition from Rand McNally remains intense for Microsoft's geographic products. Automap Streets Plus is gaining share with the introduction of the Deluxe version but there remains a tough fight to re-establish Automap Trip Planner's lost market share. Encarta World Atlas continues to grow its market share domestically and initial response to the international versions has been very favorable.

DESKTOP FINANCE REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS



- On October 10th, Microsoft announced MS Investor 2.0, a new version of its online investing service designed to help people organize and understand their personal investments and investment decisions. Investor 2.0 is an enhanced version of the Portfolio Manager, and allows users to create and track multiple stock portfolios, quickly check price and performance details of investments, access the latest business news, and instantly create historical charts. Also announced was a strategic relationship with Charles Schwab & Company Inc. and Fidelity Investments to provide users with access to online trading within Investor.
- Microsoft announced the availability of Active Statement Technology which enables web banking users to automatically read and reconcile their banking statements directly into Money 97. Wells Fargo Bank is the first major institution to agree to offer Active Statement Technology. In addition, 31 community banks and credit unions are now implementing Active Statement Technology on their web sites.
- CheckFree and Microsoft will combine technologies so that customers can connect to their financial institutions and bank through the World Wide Web in the same way they currently operate personal finance software. CheckFree's BankStreet Web product will feature Microsoft's ActiveX technology, letting banks insert a more sophisticated user interface into their website, with features similar to MS Money.
- Microsoft and Unisys have launched a mutual marketing arrangement in which Unisys will help commercial banks build and deliver home banking services by integrating their existing systems with the Microsoft products and the Open Financial Connectivity specification.

Competition

- On October 15, Intuit announced new versions of Quicken 6 and Quicken Deluxe for Windows 3.1 and Windows aimed at making getting started with personal finance software easier. The new Quicken also gives users one-click access to financial news, information and services available on the Internet without having to leave Quicken.
- Intuit announced the debut of its first ever branding TV ad campaign for Quicken. The advertising campaign, called "Get Clickin' with Quicken," supports its new easier to use version, Quicken 6.

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HARDWARE REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

- Two new hardware products. Sidewinder Gampad and IntelliMouse, were on store shelves this past holiday season. Through the end of December, over 288,000 IntelliMouse and over 437,000 Gamepads were sold. Gateway and Micron will begin shipping IntelliMouse on PCs delivered with Office 97.
- As a result of technical innovations and reduced component pricing, Intellimouse unit manufacturing costs are declining. The raw mouse started production with a cost of $8.53 and is expected to drop to approximately $4.65 by the end of Q97-4.
- The Microsoft Trackball project (with Intellimouse functionality) is well into the development process and is on schedule to ship next fall for the 1997 holiday season.
- Microsoft has won OEM Mouse business with NEC and Toshiba. Both products shipped in Q2, with logos of "Toshiba by Microsoft" and "NEC by Microsoft."
- Microsoft and Apple Computer signed a license agreement in Q97-2 allowing the Sidewinder 3D Pro to be ported to the Macintosh platform, becoming the first Microsoft Hardware device built to support the Mac. With built-in mouse control and keyboard emulation, the joystick will support most current Mac games. Microsoft will also work closely with Apple to support Apple's new sprocket technology which allows complete digital communication with the Mac.
- At the 1997 Consumer Electronics Show's "Design and Engineering Showcase," Sidewinder Gamepad and IntelliMouse received design awards endorsed by the Industrial Designers' Society of America. The products were selected by a panel of judges comprised of members of the industrial design, engineering and consumer electronics industry press.
- The Microsoft Natural Keyboard inventory is down to around 275 thousand with a target worldwide inventory of about 150 thousand. Manufacturing is ramping back up to meet demand of those units which are below required inventory levels. The increase in volumes will decrease the cost per unit resulting in OEM cost dropping from $32 to $26 per unit.
- A new keyboard is in design and is scheduled to ship in November 1997. Costs of the product are expected to drop to $12 from $18. It will replace the existing Natural Keyboard and will be an evolution of the existing design without changing the critical ergonomic angles.
- In February Microsoft will announce, Barney, the first ActiMate product at the 1997 Annual Toy Fair. Barney is an animated plush toy usable in three modes including stand alone, TV/VCR and PC mode. In the TV/VCR and PC modes, the toy will be capable interacting with the child based on data transmitted from a decoder attached to the PC or TV. A trial with the top 10 PBS stations will be completed in January and the toy will be available for the 1997 holiday season.

COMPETITION

- KeyTronic Corp. is facing 110 lawsuits brought by users of computer keyboards alleging that the company sold keyboards having manufacturing and design defects that caused or contributed to injuries identified as cumulative trauma disorder and repetitive stress injury. A jury in a similar suit returned a $6 million verdict against Digital Equipment Corporation in December. Attorneys who have handled repetitive-stress-related cases say plaintiffs now have a better chance against those computer makers that don't offer warnings, in the wake of the ruling against DEC. Microsoft's "Natural Keyboard," while believed to be easier on hands and wrists because of its banked shape, comes with a warning and offers on-line advice for typing and posturing.
- Logitech, Inc is Microsoft's major mouse competitor. MS has won some business from Logitech (Actebis, NEC & Toshiba) but has also lost accounts to them. Logitech won a Toshiba contract because they did not require a minimum unit commitment from Toshiba and MS did.

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INTERACTIVE MEDIA INVESTMENTS REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

- The Interactive Media Investment Division was created in FY97 to reflect the significant investment Microsoft is making with its interactive media partners and the increased importance of these strategic relationships. The Division currently includes MSNBC Cable and Interactive joint ventures, Dreamworks Interactive, and BET. Highlights of Interactive Media investments were covered under the Treasury section of the Board Book in FY96. Q97-2 investment in these businesses totaled $40 million.

MSNBC

- During the quarter MSNBC cable and interactive joint ventures conducted a detailed post launch business review. The original April 1996 budget was adjusted to reflect more accurate information resulting from 3 months of operations.
- Notable changes to the Cable plan as a result of the business review included an increase in cash requirements. This was due to a bond financing arrangement with the New Jersey Economic Development Association (estimated $23 million favorable impact in FY97), and an increase in cash payments to MSOs to increase distribution of the 24 hour news channel ($43 million unfavorable impact). Significant changes to the Interactive JV plan included higher headcount and related costs mainly due to higher than anticipated operational support to maintain the website. MSNBC on the Internet FY97 full time equivalent headcount (FTE's) including temps and contractors is now planned to be 196 versus original budget of 142.
- MSNBC 24 hour news cable subscribers increased from an estimated 21 million at launch date to 26 million at the end of the quarter. The increase in subscribers is above initial forecasts and reflects an aggressive effort to increase the subscriber base.
- MSNBC will open its new facility in Secaucus, New Jersey in February with all production being moved from Fort Lee to Secaucus by early April. Microsoft Q97-2 funding for the Cable JV totaled $25 million. Life to date Microsoft funding for the Cable JV as of Q97-2 was $111 million and Microsoft's share of the operating loss was $60 million.
- MSNBC on the Internet hired James Kinsella as General Manager in early October. Prior to joining MSNBC, Kinsella was the founding editor of Time Warner's Pathfinder and President of Digital Strategies, a consulting firm where he advised new media companies. Microsoft Q97-2 funding for the Interactive JV totaled $12 million. Life to date Microsoft funding for the Interactive JV was $31 million and Microsoft's share of the operating loss was $29 million.

DreamWorks Interactive

- The first four DreamWorks Interactive (DWI) titles, The Neverhood, Someone's in the Kitchen!, Steven Speilberg's Director's Chair, and Goosebumps: Escape from HorrorLand, successfully shipped into the channel for the 1996 holiday season. The Neverhood was awarded Game of the Month for December from PC Games. Goosebumps: Escape from HorrorLand received a ten out of ten on CBS Up To The Minute.
- DWI products generated $12 million in gross revenues for Q97-2, which represent year to date revenues. Microsoft's year to date share of net loss from this joint venture is $1.8 million.

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LOCALIZATION

FY97 Localization Cost by Division - Q97-2 Actual vs Budget

($ in thousands)	DBSD		IPTD		OTHER PLATFORMS		DSK		IMD		OTHER APPLNS		TOTAL	
	Q97-2 Actual	Q97-2 Plan	Q97-2 Actual	Q97-2 Plan	Q97-2 Actual	Q97-2 Plan	Q97-2 Actual	Q97-2 Plan	Q97-2 Actual	Q97-2 Plan	Q97-2 Actual	Q97-2 Plan	Q97-2 Actual	Q97-2 Plan
Headcount	*Note: Actual headcount as of December; FY97 Plan headcount = Year-end headcount*													
Japan	56	61	29	30	16	20	85	98	18	19	2	2	206	230
Redmond	60	62	50	50	70	74	89	99	4	3	10	9	283	297
Korea	9	13	9	9	2	3	20	30	0	0	2	3	42	58
Taiwan	8	11	6	7	2	3	19	22	0	0	0	0	35	43
China	5	8	5	7	0	1	15	21	0	0	0	0	25	37
Ireland	77	91	57	67	60	62	147	156	33	40	6	7	380	423
Total	215	246	156	170	150	163	375	426	55	62	20	21	971	1,088
Total Internal Cost	$ 7,489	$ 7,637	$ 5,873	$ 5,744	$ 6,235	$ 6,975	$ 10,275	$ 12,094	$ 2,258	$ 2,818	$ 517	$ 706	$ 32,647	$ 35,975
Total External Cost	$ 6,844	$ 6,743	$ 6,489	$ 7,078	$ 592	$ 2,205	$ 16,575	$ 13,770	$ 6,619	$ 9,625	$ 657	$ 859	$ 37,776	$ 40,279
Total Localization Cost														
Japan	$ 4,716	$ 5,365	$ 2,477	$ 3,086	$ 1,242	$ 1,594	$ 4,514	$ 5,162	$ 1,096	$ 1,622	$ 78	$ 177	$ 14,123	$ 17,205
Redmond	2,496	3,055	3,027	3,113	3,073	4,516	6,395	5,127	4,612	6,121	366	456	19,969	22,388
Korea	355	411	476	455	72	85	535	885	-	18	65	87	1,503	1,938
Taiwan	198	611	289	518	45	92	634	1,036	-	-	-	-	1,166	2,257
China	185	232	422	318	36	18	487	508	-	-	-	-	1,130	1,074
Ireland	6,383	4,706	5,671	5,335	2,359	2,876	14,285	13,147	3,169	4,484	665	846	32,532	31,393
Total	$ 14,333	$ 14,380	$ 12,362	$ 12,822	$ 6,827	$ 9,180	$ 26,850	$ 25,864	$ 8,877	$ 12,443	$ 1,174	$ 1,565	$ 70,423	$ 76,254

NOTE: 1) 'Other Platforms' Includes: Consumer Platforms Division (Q2=405K); Worldwide Platforms Group (Q2= 6422K)

2) 'Other Applications' includes: Desktop Finance Division (Q2=486K); Hardware (Q2=406K); Worldwide Advanced Technology (Q2=282K)

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- MS plans to localize over a thousand projects in FY97. A project is defined as a unique combination of product, version, operating system and language. This definition excludes minor localization efforts such as porting products to additional platforms or localization of retail boxes and printed documentation.

- Localization costs through Q97-2 are 92% of budget. Year to date localization costs are 80% of the budget primarily due to a number of key products for the IPTD, DSK and IMD slipping until Q97-2 and Q97-3. The table below provides a summary of the major projects in process or released during Q97-1 & Q97-2.

Major Localization Projects by Quarter

	Q1 # of language versions		Q2 # of language versions	
	In Process	RTM'd	In Process	RTM'd
DSK				
Office 97	34		31	3
Outlook 97	22		19	3
Excel 97	33		30	3
Front Page 97	4		2	2
Access 97	24		21	3
PowerPoint 97	24		21	3
Word 97	34		31	3
IPD				
IE 3.0 for W32		27		
IE 4.0 for W32	27		27	
Normandy 1.0	7		7	
Merchant 1.0	3		1	2
IE 2.1 for Mac	8			
IE 2.0 for W3.1		19		
IE 3.0 for W3.1	27			
Tools (7 products)	24		37	8
DBSD				
WINNT 4.0	2	6	8	7
Exchng 4 (q2-4.0a/5.0)	2	3	8	2
OSR 2			15	14
OSR 2.1			17	8
Courseware			19	15
Other DBSD Products			22	12
IMD				
Encarta	2	2		3
Other Multimedia Titles	49	22	50	53

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Product Support

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SALES, MARKETING & SUPPORT

Q97-2 FINISHED GOODS SUMMARY

(in millions, variance to plan)	North America		Europe		ICON		Far East		Total WW FG	
	Actual	Var%	Actual	Var%	Actual	Var%	Actual	Var%	Actual	Var%
Net Revenue	$914.9	8.9%	$748.0	23.0%	$198.6	3.6%	$281.3	27.1%	$2,143.8	14.9%
Cost of Revenue	99.6	27.8%	84.3	(1.9%)	25.9	24.0%	28.6	8.1%	237.3	18.4%
Gross Margin	816.4	15.5%	664.8	26.3%	172.7	9.7%	252.8	32.4%	1,906.5	20.8%
% of Net Revenue	89%		89%		87%		90%		89%	
Controllable Expenses										
People	42.8	11.8%	42.3	3.0%	15.4	12.4%	11.9	12.7%	112.4	8.8%
Contingent Staff	7.4	(18.0%)	3.5	1.3%	1.2	0.2%	1.7	12.7%	13.8	(8.5%)
Infrastructure	14.7	21.8%	12.1	8.8%	5.9	11.3%	4.4	2.9%	37.1	14.2%
Other Misc Expenses	11.2	(15.1%)	5.4	14.8%	4.5	(18.6%)	0.6	57.3%	21.6	(2.0%)
Sales expenses	76.0	8.6%	63.3	5.2%	27.0	7.6%	18.5	13.5%	184.9	7.8%
Marketing	117.5	14.2%	78.1	(11.4%)	17.5	(4.8%)	21.6	5.0%	232.8	4.9%
PSS Costs	72.8	10.2%	29.2	11.3%	6.8	5.8%	12.8	4.7%	121.6	8.7%
PSS Revenue	(19.7)	(17.1%)	(15.8)	30.0%	(2.4)	53.8%	(3.9)	5.6%	(41.8)	1.8%
MCS Costs	30.6	0.2%	13.3	1.3%	3.1	8.1%	1.1	5.0%	48.1	1.2%
MCS Revenue	(36.5)	10.7%	(17.0)	7.3%	(3.3)	(12.3%)	(1.0)	3.2%	(57.8)	8.0%
G&A Costs	1.7	7.4%	10.6	0.5%	2.5	7.6%	2.1	10.0%	15.9	3.3%
Total Controllable Expenses	241.8	12.5%	159.7	2.7%	51.3	5.0%	51.5	9.1%	504.2	8.5%
Responsibility Margin	574.6	33.4%	505.1	39.4%	121.4	17.5%	201.1	50.0%	1,402.3	38.1%
% of Net Revenue	63%		67%		61%		72%		65%	
Shared Resources	33.2	(19.1%)	12.8	(16.7%)	1.9	7.3%	1.8	72.5%	49.5	(4.9%)
Corporate Allocations	139.6	13.8%	97.3	13.8%	33.3	13.8%	44.9	13.8%	315.0	13.8%
Contribution Margin	$401.8	66.9%	$395.2	65.6%	$86.2	37.8%	$154.8	104.3%	$1,037.8	68.0%
% of Net Revenue	44%		53%		43%		55%		48%	
Average Sales Headcount	1,625	11.4%	1,399	5.9%	737	12.5%	427	8.4%	4,188	9.5%
People costs per head	105,297	0.2%	121,055	(3.1%)	83,446	(0.1%)	111,222	4.7%	107,320	(0.8%)
Infrastructure costs per head	36,217	11.7%	34,650	3.1%	32,141	(1.4%)	41,059	(6.0%)	35,470	5.2%

FY97 YTD FINISHED GOODS SUMMARY

(in millions, variance to plan)	North America		Europe		ICON		Far East		Total WW FG	
	Actual	Var%	Actual	Var%	Actual	Var%	Actual	Var%	Actual	Var%
Net Revenue	$1,741.0	13.1%	$1,199.9	19.1%	$353.7	2.0%	$531.8	22.8%	$3,826.4	16.0%
Cost of Revenue	185.9	22.8%	133.1	2.5%	49.3	24.5%	55.4	5.2%	423.7	15.4%
Gross Margin	1,555.1	22.3%	1,066.8	22.5%	304.4	8.2%	476.4	27.1%	3,402.7	21.8%
% of Net Revenue	89%		89%		86%		90%		89%	
Controllable Expenses										
People	87.0	11.5%	82.2	8.3%	29.9	16.2%	23.4	11.4%	222.5	11.0%
Contingent Staff	12.5	7.6%	5.8	18.2%	2.4	3.9%	3.2	11.0%	23.9	10.5%
Infrastructure	29.0	20.0%	22.2	13.4%	11.4	13.9%	8.4	5.2%	71.0	15.5%
Other Misc Expenses	18.7	(6.8%)	10.1	8.0%	7.6	1.3%	2.8	13.3%	39.0	0.5%
Sales expenses	147.2	11.1%	120.3	8.8%	51.2	13.2%	37.7	10.2%	356.4	10.9%
Marketing	203.2	22.1%	109.4	4.2%	28.1	16.8%	33.1	23.6%	373.9	17.3%
PSS Costs	142.1	12.5%	56.7	13.7%	13.0	10.5%	25.1	8.3%	236.9	12.3%
PSS Revenue	(38.7)	(10.8%)	(23.4)	9.2%	(4.0)	26.0%	(6.1)	2.1%	(72.1)	(2.4%)
MCS Costs	58.8	(0.6%)	24.8	4.4%	5.9	12.1%	2.2	4.5%	91.7	1.8%
MCS Revenue	(66.3)	8.9%	(29.1)	6.4%	(6.5)	(9.5%)	(1.8)	(14.1%)	(103.5)	6.3%
G&A Costs	1.8	(20.0%)	20.0	5.3%	5.1	7.1%	4.3	11.7%	31.1	5.4%
Total Controllable Expenses	448.1	17.7%	278.7	10.5%	92.9	15.0%	94.8	15.5%	914.9	15.1%
Responsibility Margin	1,107.0	52.3%	788.1	40.9%	211.5	23.0%	381.6	45.3%	2,488.8	44.6%
% of Net Revenue	64%		66%		60%		72%		65%	
Shared Resources	57.9	(3.9%)	21.9	2.3%	3.5	18.3%	8.8	48.4%	90.2	5.2%
Corporate Allocations	266.3	17.6%	185.5	17.6%	63.5	17.6%	95.0	17.6%	600.9	17.6%
Contribution Margin	$782.9	125.0%	$581.8	86.1%	$144.5	50.3%	$280.0	98.1%	$1,798.3	100.6%
% of Net Revenue	45%		46%		41%		54%		47%	
Average Sales Headcount	1,821	11.7%	1,376	6.7%	705	15.0%	404	7.1%	4,110	10.2%
People costs per head	107,401	(0.2%)	119,420	1.7%	84,777	1.4%	113,223	4.7%	108,134	0.8%
Infrastructure costs per head	35,780	8.4%	32,280	7.7%	32,229	(1.3%)	46,780	(2.1%)	34,580	5.8%

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CHANNEL HIGHLIGHTS

- Finished goods net revenue for Q97-2 was $2.14 billion, 15% over plan, including $48 million (2%) positive variance due to foreign exchange rates.
- All four geographic areas exceeded net revenue plan in the quarter, led by the Far East which was 27% over plan. The top 10 net FG revenue subsidiaries were the U.S., Japan, United Kingdom, Germany, France, Canada, Italy, Australia, Switzerland and Sweden. Notably, the U.K. has passed Germany to be the 3rd largest and of the top 10 subs. Australia was the only one below plan. Aggregated, these 10 subs represent 82% of FG net revenue. Of the smaller subs, the most notable is the People's Republic of China, which has grown 193% over the prior year and has moved from the 49th largest sub to the 39th in terms of net revenues.
- Gross margin from finished goods for Q97-2 was 89% versus plan of 85%. The principal driver was lower product costs in all geographies due to significant sales shifts toward licensing and CD media. See Operations section for more analysis on cost of finished goods revenues.
- Sales expense for Q97-2 was 7.8% below plan due to average headcount being 9.5% below plan. On a per head basis, people costs were 1% over plan for the quarter but below plan on a year to date basis primarily due to lower than plan travel expenses.
- Q97-2 marketing expense was $233 million, 11% of net revenue, 5 points below plan. On a year to date basis, marketing spend was 17% below plan and represented 46% of the full year budget.
- PSS costs net of recovery decreased 35% from Q96-2 levels and were 4% of net finished goods revenue in the quarter compared to a plan of 5%. Gross PSS costs were 10% under plan due to lower incidents and lower headcount.
- Responsibility margin for the quarter was 65%, equal to Q97-1 which was the most profitable quarter ever and was 12 percentage points better than Q96-2. All regions exceeded planned responsibility margin for Q97-2.

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Worldwide Finished Goods Gross Revenue Ranking - FYTD 97 (000s)	97 Actual	97 Budget	% of Budget	96 Actual	% Growth	% of Total Actual
1 United States	[illegible]973	1,521,994	115.1%	1,720,877	1.8%	43.1%
2 Japan	[illegible]475	385,313	123.7%	395,789	20.4%	11.7%
3 Germany	[illegible]91	223,702	118.5%	329,023	-19.4%	6.5%
4 United Kingdom	[illegible]759	204,611	129.4%	244,878	8.1%	6.5%
5 France	[illegible]360	167,328	120.3%	219,668	-8.3%	5.0%
6 Canada	[illegible]38	110,576	118.6%	122,141	7.4%	3.2%
7 Italy	[illegible]64	79,859	106.9%	94,371	-9.8%	2.1%
8 Australia	[illegible]229	92,292	90.2%	104,449	-20.3%	2.0%
9 Switzerland	[illegible]238	49,490	123.7%	76,715	-20.2%	1.5%
10 Sweden	[illegible]8,456	53,604	109.1%	65,939	-11.3%	1.4%
11 Netherlands	55,628	42,318	131.5%	50,080	11.1%	1.4%
12 Brazil	46,979	47,590	98.7%	34,525	38.1%	1.2%
13 Belgium	[illegible]971	29,322	139.7%	39,131	4.7%	1.0%
14 Spain	[illegible]084	32,053	112.6%	35,516	1.6%	0.9%
15 Denmark	[illegible]639	28,096	112.8%	33,920	-6.5%	0.8%
16 South Africa	[illegible]	23,765	126.3%	22,493	33.4%	0.7%
17 Korea	[illegible]416	26,911	105.6%	24,873	14.2%	0.7%
18 Mexico	[illegible]401	25,603	110.9%	20,960	35.5%	0.7%
19 Norway	[illegible]894	24,294	102.5%	27,979	-11.0%	0.6%
20 Austria	[illegible]983	18,791	127.6%	26,051	-7.9%	0.6%
21 Finland	22,539	18,737	120.3%	24,013	-6.1%	0.6%
22 Taiwan	2[illegible]406	15,693	136.4%	14,900	43.7%	0.5%
23 Czech Republic	[illegible]8,078	17,991	100.5%	18,066	0.0%	0.4%
24 Hong Kong	17,706	19,193	92.3%	20,053	-11.7%	0.4%
25 New Zealand	[illegible]6,915	16,451	102.8%	23,584	-28.3%	0.4%
26 Singapore	[illegible]6,767	17,903	93.7%	17,676	-5.1%	0.4%
27 Portugal	[illegible]6,711	13,890	120.3%	14,690	13.8%	0.4%
28 Poland	[illegible]5,559	16,423	94.7%	14,256	9.1%	0.4%
29 Argentina	13,972	12,476	112.0%	10,770	29.7%	0.3%
30 Colombia	12,666	13,233	95.7%	11,016	15.0%	0.3%
31 Malaysia	12,290	11,435	107.5%	8,624	42.5%	0.3%
32 India	11,195	10,144	110.4%	8,535	31.2%	0.3%
33 Israel	11,072	9,993	110.8%	6,429	72.2%	0.3%
34 Thailand	9,721	9,861	98.6%	9,596	1.3%	0.2%
35 Chile	9,516	9,214	103.3%	7,132	33.4%	0.2%
36 Gulf	9,229	5,257	175.6%	5,101	80.9%	0.2%
37 Caribbean	9,142	9,206	99.3%	7,161	27.7%	0.2%
38 Hungary	8,790	10,368	84.8%	11,462	-23.3%	0.2%
39 China	8,045	5,897	136.4%	2,703	197.6%	0.2%
40 Turkey	7,708	7,000	110.1%	5,532	39.3%	0.2%
41 Russia	7,327	7,976	91.9%	7,085	3.4%	0.2%
42 Venezuela	7,174	7,147	100.4%	4,503	59.3%	0.2%
43 Slovakia	5,412	5,248	103.1%	2,696	100.8%	0.1%
44 Saudi Arabia	5,365	5,100	105.2%	1,976	171.5%	0.1%
45 Peru	5,335	5,360	99.5%	4,039	32.1%	0.1%
46 Greece	4,981	4,469	111.5%	3,802	31.0%	0.1%
47 Philippines	3,730	2,721	137.1%	1,823	104.7%	0.1%
48 Egypt	3,141	2,229	141.0%	1,493	110.5%	0.1%
49 Indonesia	2,999	2,316	129.5%	1,532	95.8%	0.1%
50 Morocco	2,759	2,696	102.3%	1,612	71.1%	0.1%
51 Slovenia	2,647	3,511	75.4%	2,888	-8.3%	0.1%
52 Eastern Europe	2,639	2,170	121.6%	2,217	19.0%	0.1%
53 West Africa	2,149	2,573	83.5%	514	318.4%	0.1%
54 Ecuador	2,111	2,681	78.7%	1,647	28.2%	0.1%
55 Uruguay	1,936	1,680	115.2%	1,262	53.5%	0.0%
56 Southern Sub Sahara	1,331	1,339	99.5%	1,166	14.2%	0.0%
57 Romania	1,328	723	183.6%	549	142.0%	0.0%
58 Indian Ocean Islands	1,147	1,027	111.7%	127	801.9%	0.0%
59 Croatia	1,013	794	127.7%	740	36.8%	0.0%
60 East Africa	538	527	101.8%	968	-44.6%	0.0%
61 L. America Other	387	0	n/a	261	48.1%	0.0%
62 Vietnam	385	648	59.4%	101	280.5%	0.0%
Grand Total	4,060,911	3,506,611	116.0%	3,973,674	2.2%	100.0%

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GROSS REVENUE HIGHLIGHTS

- Q97-2 Finished goods (FG) gross revenue was $2.33 billion, 16% above plan and a 34% increase over Q97-1. Year to date channel gross revenues of $4.06 billion grew 2% over the prior year which included the Desktop 95 launch. Excluding the channel reserves taken for excess Desktop 95 channel inventory, year over year growth was 22%.
- All geographic areas exceeded Q97-2 and year to date gross revenue plan. The Far East exceeded Q97-2 plan by 27% on the strength of localized versions of Windows 95 and Windows NT 4.0 products. Europe was 24% above Q97-2 plan due to strong licensing of Office and Office Professional in addition to FPP sales of Windows NT Workstation/Server and Interactive Media products. North America gross revenue was 11% above plan, with higher sales of DAD, DSD and BSD products offset by lower than plan sales of Interactive Media and Hardware products. Licensing of Office and Windows NT Workstation. FPP sales of the Win95/IESK bundle and the late December sell-in of Office97 were the primary factors. ICON gross revenue was 7% above plan in Q97-1. The principal driver was the strength of DAD MOLP sales.
- FG channel sales of Interactive Media products in Q97-2 were $156M, $22 million (16%) above plan and 87% above Q96-2 reflecting the holiday seasonality. Better than expected sales of Flight Simulator and Encarta in Europe offset lower than planned sales of games in North America. An returns reserve of $33 million has been recorded for excess Interactive Media products' channel inventory based on the most recent post holiday sell through estimates. Desktop and Business Systems divisions were above plan $153 million and $63 million respectively due to strong MOLP and Select billings. Hardware and IPTD were the only divisions below gross revenue plan for the quarter due to weak sales of Keyboards and the slip in the release of Version 5.0 of developer tools.

Q97-2 Worldwide FG Gross Revenue

amount in millions, variance to plan	North America		Europe		Far East		ICON		Worldwide FG	
	Actual	% Var	Actual	% Var	Actual	% Var	Actual	% Var	Actual	% Var
Desktop Apps	510.4	16%	448.6	17%	155.5	2%	127.4	8%	1,241.8	14%
Interactive Media	76.6	-7%	63.1	62%	3.8	51%	12.4	23%	155.8	16%
Hardware	48.2	-34%	25.7	23%	6.4	57%	7.9	17%	88.2	-16%
Desktop Finance	2.6	-33%	3.3	-10%	0.0	-64%	3.3	530%	9.1	14%
Desktop Systems	173.7	50%	92.4	45%	46.0	259%	23.8	-1%	335.9	55%
Business Systems	147.6	23%	110.4	26%	49.1	33%	32.7	0%	339.8	22%
Internet Platforms and Tools	54.2	-33%	32.4	-3%	27.2	67%	6.2	-28%	120.1	-14%
Other	15.4	37%	13.4	77%	4.7	-29%	2.2	57%	35.7	33%
Grand Total	1,028.6	11%	789.3	24%	292.7	27%	215.9	7%	2,326.5	16%

YTD Worldwide FG Gross Revenue

amount in millions, variance to plan	North America		Europe		Far East		ICON		Worldwide FG	
	Actual	% Var	Actual	% Var	Actual	% Var	Actual	% Var	Actual	% Var
Desktop Apps	924.8	9%	738.9	13%	305.0	3%	223.3	2%	2,191.7	9%
Interactive Media	100.9	2%	71.1	48%	7.3	60%	17.7	19%	196.9	18%
Consumer Input Devices	73.0	-28%	34.6	14%	10.5	47%	12.6	10%	130.7	-13%
Desktop Finance	3.3	-35%	3.2	-29%	0.0	-79%	3.3	247%	9.9	-7%
Desktop Systems	351.6	75%	144.6	42%	71.4	159%	41.6	-2%	609.2	63%
Business Systems	294.7	34%	181.2	25%	90.7	22%	58.7	1%	625.3	26%
Internet Platforms and Tools	112.9	-18%	56.2	5%	57.1	83%	12.3	-22%	238.5	0%
Other	22.2	0%	21.8	51%	9.9	-25%	4.7	115%	58.6	13%
Grand Total	1,883.1	15%	1,251.5	19%	552.0	22%	374.3	3%	4,060.9	16%

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NORTH AMERICA HIGHLIGHTS

- Enterprise Customer Unit activities during Q97-2 included closure of large custom deals and the introduction of the Select 4.0 volume licensing program. Custom deals designed to increase long-term revenue per desktop, customer satisfaction and field selling efficiency were signed with Boeing, MCI, Lockheed, British Telecom and Chrysler amounting to approximately $75 million in revenue over the next 3 years.
- The Microsoft Solution Provider (MSP) 97 program was launched in December with greater emphasis on online interaction. There are currently twelve thousand MSP's worldwide and more than 538 have attained partner level status. The number of partners is expected to increase to 700 by the end of the fiscal year.
- The MCP program has increased certifications to 109 thousand up from 66,000 certifications at the end of FY96, an increase of 64%. Currently there are a total of 94 thousand certified individuals compared with an estimated 115 thousand Certified Novell Engineers (CNEs) worldwide.
- MS introduced an Internet certification program in early December in order to standardize qualifications for creating and maintaining web servers.
- Over the past 6 months, Microsoft reseller breadth programs run by the Organization Customer Unit (OCU) have reached over 24 thousand resellers in seminars and events and trained nearly 10 thousand resellers on Windows NT Server, Exchange and Internet products. OCU also sold over 5400 Reseller Action Packs.
- OCU invited association leaders to help small businesses through the Internet. Among the first beneficiaries have been CPA associations. 34 of the 52 associations are now endorsing Microsoft Internet Standards.
- Two End User Customer Unit (EUCU) marketing initiatives completed during Q97-2 helped sustain Windows 95 and Office 95 momentum. Standalone Windows 95 was replaced with a bundle of Windows 95 & Internet Explorer Starter Kit 3.0 on October 15th, and Office 95 purchasers were guaranteed a free upgrade to Office 97 when purchased between October 1st and January 16th.
- EUCU is preparing to launch Office 97 with direct marketing catalogs, advertising, merchandising, and "demo-days" at retail outlets. Sell-through and inventory levels of Office 95 are being monitored on a weekly basis as retail and direct marketing resellers begin to reduce inventory levels in anticipation of the product launch.
- The Education Customer Unit (EdCU) sold 400 thousand Windows 95 units to Higher Education and K-12 customers through the Windows 95 Special Promotional Offer for Education, which ended October 31st. Under this offering, any educational institution had the opportunity to purchase to package product of Windows 95 at $19.95 each.
- In December, EdCU released Microsoft Communications Tools for Schools, a collection of email, video-conferencing, communications, and Internet tools running on Windows NT Server that are tailored for K-12 education. The offer is available through August 1997.
- MS joined seven leading higher education associations in the formation of Partners for the Advancement of Technology in Higher Education (PATH), an organization that will help colleges and universities address issues of information technology and offer real-world solutions to the challenges they face.

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EUROPE HIGHLIGHTS

- The US dollar continues to strengthen relative to most of the European currencies with the exception of the British Pound. For Q97-2, the average exchange rate was 5.19 French Francs and 1.54 Deutsche Marks for each US dollar in comparison with an average exchange rate of respectively 5.09 French Francs and 1.51 Deutsche Marks at the end of Q97-1. In contrast, the British Pound went from 0.61 to 0.58 to the US dollar. These rates reflect the activity in the foreign exchange markets and vary marginally from the internal exchange rates used to convert financial statements. See Results section for details of the internal rates.
- With the exception of the United Kingdom and the Netherlands, unemployment rates are continuining to increase in most of the European countries. In addition, retail sales growth rates improved in France from 1.4% in Q97-1 to 4.4% in Q97-2 and decreased in Germany from + 4.3% to -0.8% for the same periods.
- The Distribution Market in Europe is maturing fast and is still highly [illegible]. Computer 2000, by

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far the largest distributor in Europe, has little more than 10% share of the PC market. Many distributors continue to make small profits but only a few have access to capital such as Ingram Micro, Tech Data and Arrow.

- HIS Trivial Info, the largest software dealer in France, has been purchased by ASAP Software, the third largest software dealer in the US. More and more US software dealers or US hardware dealers are looking to expand into Europe, often by acquiring European companies.
- Telefonica, the National Spanish Telecomunication company, has decreased its price for Infovia, its Internet service, to 125 pesetas (less than 1 USD) an hour, including telecom time. In November, Microsoft Spain started selling Windows 95 with the Infovia access pre-loaded.
- Spain is recovering from one of the most severe recessions in Europe. Despite an unemployment rate of over 20%, PC units sales are expected to climb 23% to 844 thousand. Tougher laws combined with new license packs aimed at small and medium sized business are reducing piracy resulting in higher software sales. The Business Sotfware Alliance expects piracy rates to fall from 74% to 68% in calendar year 1996.
- Microsoft Germany started a short term promotional activity with Vobis and Escom using consignment inventory as a vehicle to place products at points of sale. The promotion will run through the end of February 1997 and includes products worth 13 million Deutsche Marks, (approximately $8.6 million USD) and a reserve of 0.8 million Deutsche Marks has been recorded for obsolescence and scrap of returned products.
- A special deal for Mouse has been closed with Siemens Nixdorf and Microsoft Germany for the period from August 1996 to December 1996. The majority of the mouse were shipped without a PC and were used for a special mouse replacement deal between Siemens Nixdorf and the German Tax advisor association DATEV. 750 thousand units were shipped by December at a unit price of 11 DM.
- ZDF, the largest German TV station, endorsed the Internet Explorer Starter kit in December broadcasts. Additional spots will be produced and broadcast in various computer magazines during next calendar year. Microsoft Germany is allowed to use the ZDF brand (Endorsed by ZDF) for all our IESKs.
- In Portugal, the private network that links the Ministers of the Portuguese government is now based on Microsoft BackOffice with Exchange as the messaging platform. The Ministry of Finance is now the largest MS Back Office user in the Portuguese public administration with 500 servers and 1,200 users expected when the project is fully deployed.
- Competition is very active everywhere in the Southern Europe Region. IBM is aggressively targeting Small Business and Strategic Partners with SmartSuite bundles at very low prices ($16 to $20), big investments in advertising and Domino Internet Road Shows. Novell is also investing substantially in Portugal and Italy for adverstising and funds aimed at the distributors.
- Netherlands had a great quarter, 26% over plan in net revenues and 43% over plan in responsibility margin. This was partially attributable to the country's excellent economic condition. Gross Domestic product is forecasted to rise to 2.9% this year from 2.4% in calendar year 1995, inflation is under control at 2% and Netherlands has one of the lowest unemployment rate in Europe at 6.5% and is forecasted to fall to 6.1 % in 1997.
- Microsoft France signed its largest Select contract with CNAM, the French social security company, for a planned revenue over the next 2.5 years of 70 million French Francs, approximately $14 million USD. This contract includes 30,000 new Office licences and 29,000 upgrades of their existing Office installed base plus 1,200 new Windows NT servers and 50,000 new Windows NTS CALs.
- A French localized version of Encarta was successfully launched during the quarter with 32,000 units sold through after 6 weeks of sales. Despite very strong local competition, Encarta leads with a 55% dollar market share.
- On December 30, 1996, Microsoft Hrvatska Doo, the new Croatian subsidiary was incorporated with Goran Radman as the General Manager.
- In November, Microsoft Switzerland had its Internet exhibition in the biggest hall in the country. ABB, Compaq, DEC, Swiss Bank Corporation, Sonntag Zeitung, and many other companies sponsored this event along with Microsoft.
- Microsoft Austria was the first to setup an online banking solution with Austrian bank BAWAK. Other banks in Austria are now asking for similar arrangements with Microsoft.
- To increase Internet Explorer logos on the United Kingdom Internet, Microsoft Ltd has made a deal with the largest UK "What's New" homepage. This is an exclusive deal and has helped increase

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Internet Explorer logos from 10% to 60% within a month.

- During the second half of the 1996 calendar year, MS has increased its browser share 31 percentage points to 35% in the United Kingdom.

FAR EAST HIGHLIGHTS

- The US dollar continued to strengthen relative to the Japanese Yen to 115.8 Yen for each US $ at the end of CY96. The average exchange rate for Q97-2 was 109.6 Yen, up from 105.6 Yen in Q97-1 and 100.8 Yen in Q96-2. The budgeted rate for FY97 is 115 Yen for each US $. In Q97-2, gross FG revenue for the region was $61 million over plan of which $11 million was due to favorable foreign exchange.
- Localized versions of Windows 95 have added to the continued adoption of Windows family as the standard platform in the Far East. The Windows penetration rate (all versions of Windows on Intel PC shipments) in the Far East increased to 83% in FY96, up from 67% in FY95. In FY97, the Windows penetration rate is forecasted to be 88%. Q97-2 FG revenue in the Far East region of Windows 95 was $20 million, 183% over plan.
- Japan finished the quarter with gross FG revenue of $252 million and is the second largest subsidiary after the United States. Gross FG revenue for Japan for Q97-2 grew 17% (in local currency) over Q97-1, due in part to the continued adoption of Windows and the launch of Japanese version of Windows NT 4.0. MS Japan contributed 11% of Microsoft's worldwide FG revenue in Q97-2.
- Year to date gross FG revenue for each of the Far East subsidiaries, except Hong Kong, was above plan. Gross FG revenue for Hong Kong was 10% behind plan for Q97-2 and 8% behind plan for first half of the year. Management of Hong Kong believes that this shortfall is due in part from the slowing demand from the government sector in Hong Kong, caused by the anticipation of the revision of Hong Kong to Chinese rule on July 1, 1997. In addition, there was excess MS product in the channel at the start of the FY97.
- The Japanese version of Windows NT 4.0 products were launched on December 10, 1996, with Bill Gates giving the keynote speech at the Window NT Intranet Solutions event in Tokyo. Gross FG revenue from Windows NT products represented 34% of the total gross FG revenue for the region for the month of December.
- The release of the Japanese version of Windows NT 4.0 products contributed to BSD revenue being 33% over plan in Q97-2. In addition, the continued success of other localized versions aided BSD revenue in Q97-2. The Japanese versions of Exchange 4.0 and SQL Server 6.5 and the DBCS enabled version of SQL Server 6.5 for the other subsidiaries shipped in Q97-1.
- Just Systems' Ichitaro for Windows is the leading word processing program in Japan, with an estimated 69% market share of the standalone word processing market in FY96. In Q97-1, Just Systems' shipped Ichitaro for Windows 7.0. Area Hangul's word processor program is the leading word processor in Korea. Area Hangul shipped updated versions of their word processor program and office suite in September 1996. The release of these competitive versions has caused increased pressure on price points and market share for both MS Japan and MS Korea. MS's response to this competition is the localized version of Office 97, scheduled to be released in the next quarter.
- PC sales in Japan grew by 62% in FY96 over FY95 driven by lower prices of PCs and software, and easier to use systems. At the completion of the annual financial plan, PC sales in Japan were expected to slow to 24% growth in FY97. Our current estimate is that PC growth in FY97 will slightly exceed that rate.
- Approximately 60%, (up from 52% in Q96-4) of all Windows 95-capable PCs shipped in Japan were bundled with word processor or spreadsheet software. MS's strategy in Japan is to aggressively pursue bundling Japanese versions of 32-bit Excel and Word with all OEMs and our current market share for this segment is estimated to be about 40%. Licenses from the pre-installed Word/Excel bundle represented approximately 34% of all Desktop apps licenses for MS Japan for year to date FY97. The combined average revenue per license for the pre-installed Word/Excel bundle was $88.
- In October 1996, Software of Japan (fourth largest customer of MS Japan) merged with Catena, the third largest customer, as a result of financial difficulties. At the time the merger plans were announced, our accounts receivable balance from Software of Japan was approximately $5 million, all of which was subsequently collected by MS Japan or MS product returned.
- On December 17, 1996, the Simplified Chinese version of Windows 95 was re-launched in the

PRC, after eliminating the anti-Communist sayings in the input editor.

- Management of MS China is continuing to take measures to establish local operations. In December 1996, our wholly owned subsidiary in China started to bill distributors in Renminbi and establish local treasury functions. MS' outsource manufacturer located in Shanghai has started to source raw materials locally, reducing the dependence on importing the raw materials into the country. In addition, a comprehensive benefit package was implemented for MS employees in China.
- The general manager of MS Korea recently resigned and a replacement is actively being sought.

ICON HIGHLIGHTS

- Microsoft has ended its relationships with third party Distributed Manufacturers (DM) in South Africa (Creda) and Brazil (Sonopress). This followed negotiations over several months that ended with the conclusion that pricing economies and other efficiencies, which can be achieved using EOC and KAO at Canyon Park, outweigh potential gains from better product availability. There is no financial exposure with Sonopress, but Creda will have a minimum penalty $250 thousand which has been accrued. There may be additional exposure above this amount for inventories they still have on hand.
- ICON continues to experience several impacts beneficial to gross margin performance. Penetration of licensing products has improved beyond plan. MOLP volumes consistently exceeded 25%; New Maintenance was 14% year to date and CD penetration was above 80% in several subs. Each of these contributes significant benefit to gross margin. ICON gross margin is 86% of net revenue YTD, 87% in Q97-2. This compares to year to date plan of 81%.
- Inventories for ICON are $24 million. Of these, $15 million are deemed at risk, compared to reserves of $16 million. The excess covers inventory held at supplier sites. Much of this total resides in and around South Pacific, covering issues ranging from Desktop 95 exposures awaiting return, to oversupply of Gamepad and other input device products over forecast for the Christmas season. Resolution of these issues and implementation of the ICON goal of reducing inventories should see these inventories and associated reserves reduced through the remainder of FY97.
- Government spending in Australia and Singapore has contracted significantly. MS has suffered from this reduced expenditure in line with other companies in our industry and across the economy. Slow recovery is expected through Q97-3 and Q97-4 revenue impact is expected to be neutral by year-end.
- Work continues in negotiating a possible joint venture with a business partner in Saudi Arabia in lieu of the present, complex agency relationship with little or no control. Saudi law requires that MS allow a Saudi owned company to transact all business in Saudi on its behalf. The status of a joint venture gives MS legal control over the business relationship and places formal responsibilities on our partners. The intention is to also improve MS's position within the market, both legally and in appearance, to allow MS staff to do more to further our goals there.
- Contracts were completed and signed with Tech Data (TD) in Q97-2, whereby Microsoft will provide loan funding up to $4.6 million to incent them to begin operations in Brazil significantly ahead of their own internal timetable. Funding in the current quarter was $2.6 million. The repayment of this sum to Microsoft is conditional on TD's ability to generate revenues with a potential for them to so over perform that the entire loan would be forgiven. It's anticipated that TD will be open for business in Brazil by February 1997.
- The unsteady nature of the Brazilian market was again illustrated by the Government liquidation of Interunion Bank, owners of MS' second largest distributor in Brazil, Lasoft. Even though Lasoft's business and it's liability to MS appear secure, Interunion has stated its intention to sell Lasoft and, in the process, MS has been denied parental and material guarantees over the accounts receivable of approximately $10 million Lasoft presently carries with Microsoft.
- Business in Africa is expanding rapidly with new offices in Abidjan (Ivory Coast) and Nairobi (Kenya) opened in the quarter. Recruitment to staff these offices will continue through the next two quarters in line with revenue growth. Investigation of proposals for similar offices throughout Africa is ongoing.

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OEM REVIEW

(in millions, variance to plan)	Q97-2		Year to date	
	Actual	Var%	Actual	Var%
Net Revenue	$1,004.9	24.9%	$1,748.5	21.1%
Cost of Revenue	34.0	(3.4%)	59.0	2.1%
Gross Margin	970.9	25.9%	1,689.5	22.1%
% of Net Revenue	97%		97%	
Controllable Expenses				
People	7.8	3.6%	14.8	8.2%
Contingent Staff	0.1	59.0%	0.3	(22.2%)
Infrastructure	1.7	12.8%	3.5	10.4%
Other Misc Expenses	23.8	(25.0%)	40.8	(18.7%)
Sales expenses	33.4	(14.1%)	59.4	(8.7%)
Marketing	5.5	26.9%	7.0	51.6%
PSS Costs	1.8	21.5%	3.3	28.3%
G&A Costs	0.5	(15.3%)	0.8	6.0%
Total Controllable Expenses	41.1	(4.3%)	70.5	5.4%
Responsibility Margin	929.7	27.0%	1,619.1	23.6%
% of Net Revenue	93%		93%	
Shared Resources	0.2	·2.8%	0.3	19.9%
Corporate Allocations	133.6	·4.2%	255.6	17.8%
Contribution Margin	$795.9	38.2%	$1,363.2	36.5%
% of Net Revenue	79%		78%	
Average Headcount	261	4.0%	258	4.1%
People costs per head	119,571	(0.5%)	114,643	4.3%
Infrastructure costs per head	26,360	9.1%	26,853	6.6%

BUSINESS HIGHLIGHTS

- Q97-2 was OEM's first billion-dollar quarter. Revenue grew 41% over Q96-2 and 35% over Q97-1. All geographical regions were over budget, as were all product divisions except Interactive Media. Volume drove most of the revenue variances.
- Windows 95 penetration increased to 78% of the desktop operating system units reported in Q97-2. Windows NT Workstation units more than doubled, with 365,000 units reported.
- The Systems Builders (SB) channel again had a record quarter, reporting $197 million of revenue. Europe contributed 53% of this revenue, outperforming plan by 52%. Year to date, the Far East region's revenue of $26 million exceeded their entire FY97 budget of $25 million.
- Q97-2 Mouse sales totaled 4 million units, 19% over budget, despite the existence of counterfeit and unbundled Mouse in several areas of the world.
- Q97-2 cost of revenue was greater than plan primarily due to mouse units being greater than plan. A $1 million obsolescence reserve was taken for serial mouse. All slow-moving product is adequately reserved for obsolescence.
- Marketing remains below budget due to limited use of the discretionary fund and less costly programs than anticipated.
- PSS costs were below plan because actual expenses for MS-supported OEM programs such as the PowerPC were much lower than budgeted. In addition, cost per call was less than budgeted.
- Bad debt and B&O tax accruals, which are revenue driven, were the principal reason for Miscellaneous Expenses to have a negative variance this quarter

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Significant Customers

(in millions)	Q97-2 Actual	Q97-2 Plan	Q97-2 Variance	FYTD97 Actual	FYTD97 Plan	FYTD97 Variance	FYTD Growth $	FYTD Growth %
Top 10 Multinationals								
IBM	$ 85.1	$ 54.5	$ 30.6	$ 149.8	$ 93.6	$ 56.2	$ 82.1	82%
Dell	64.9	51.4	13.5	111.2	92.4	18.8	58.4	90%
Compaq	57 9	57 2	0.7	105.0	109.9	(4.9)	85.6	23%
Gateway 2000	57 0	51.5	5.4	97.5	98.8	(1.2)	62.8	55%
Packard Bell	43.1	47.8	(4.7)	61.2	84.6	(23.3)	65.3	(6%)
Hewlett Packard	41 9	39.0	2.9	76.8	74.1	2.8	44.1	74%
Toshiba	40 3	27.9	12.4	68.4	53.0	15.5	39.8	72%
NEC	37.8	42.0	(4.2)	59.1	77.8	(18.6)	77.3	(23%)
AST Research	19 9	16.8	3.2	35.7	29.3	6.5	35.7	(0%)
Acer	17 7	20.7	(3.0)	40.4	38.2	2.2	45.6	(11%)
Other Multinationals	90 2	78 4	[illegible]	150.0	128.8	21.2	136.0	10%
Total Multinationals	545.8	487.1	58.7	955.3	880.3	75.0	732.6	30%
Named Accounts	252.9	192.6	45.3	448.1	348.6	99.5	351.7	27%
System Builders	196.9	126.1	38.7	336.7	218.6	118.1	150.1	124%
Gross Revenue	995.6	805.8	142.7	1,740.2	1,447.5	292.7	1,234.4	41%
Revenue Adjustments	9.3	(1.6)	0.6	8.3	(3.1)	11.5	(54.0)	
Net Revenue	$ 1,004.9	$ 904.2	$ 143.3	$ 1,748.5	$ 1,444.4	$ 304.1	$ 1,180.4	48%

- IBM is now #2 in worldwide PC shipments partially due to increased sales-out incentives offered to the channel. Increased unit shipments, combined with royalties from legacy products such as OS/2 and LAN Manager, made IBM the largest customer for the second consecutive quarter. Of the $150 million year to date revenue received from IBM, 74% was related to Windows 95.

- Dell continues to benefit from the efficiencies of the build-to-order model allowing them to keep low inventory volumes (12 days of inventory compared to Compaq's 39 days) resulting in lower cost and quick adoption of new technology. These factors give Dell a pricing advantage, which has been used successfully to increase market share. In September, Dell expanded this concept into the server market, launching an NT-based server line priced as much as 55% below competitors' servers resulting in other OEMs cutting server prices.

- Compaq, the #1 PC shipper, expanded its product offerings by increasing its efforts in the enterprise market and launching a line of NT-based workstation and network products. The company also introduced a PC Companion based on Windows CE.

- Second-time buyers account for 65% of the consumer market, up from less than 50% two years ago. Direct marketers, such as Gateway 2000, appeal to these experienced buyers with customized machines at low prices. Gateway has the highest royalty/PC of all our multinational OEMs because it bundles Office and Office Pro with its machines. Non-OS products account for 58% of Gateway's royalties.

- Packard Bell and Acer, traditional low priced OEMs for first-time buyers, have been hurt by the shift in the consumer market toward direct marketers, as well as competition from new desktop entrants such as Sony and Toshiba. To lure more first-time buyers, Packard Bell has recently introduced a Pentium PC for $999, including monitor and disk drive.

- Toshiba, the market leader in portables, entered the consumer desktop market and anticipates entering the corporate market this spring. Desktop systems accounted for 20% of units shipped in October and November.

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PUBLIC NETWORK SALES REVIEW

P&L SUMMARY

(in millions, variance to plan)	Q97-2		Year to date	
	Actual	Var %	Actual	Var %
Net Revenue	$10.2	50.4%	$11.8	(4.9%)
Cost of Revenue	0.0	100.0%	0.0	100.0%
Gross Margin	10.2	63.7%	11.8	2.4%
% of Net Revenue	100%		100%	
Controllable Expenses				
People	2.7	9.9%	4.9	13.5%
Contingent Staff	0.0	42.9%	0.1	45.5%
Infrastructure	0.6	17.9%	1.1	19.3%
Other Misc Excenses	0.0	(288.9%)	0.0	(105.6%)
Sales & Marketing expenses	3.4	11.5%	6.2	15.1%
Marketing	0.3	76.3%	0.6	69.0%
PSS Costs	0.0	100.0%	0.0	100.0%
G&A Costs	0.1	0.9%	0.2	16.7%
Total Controllable Expenses	3.7	29.3%	7.0	30.5%
Responsibility Margin	6.5	580.9%	4.8	232.7%
% of Net Revenue	63%		41%	
Shared Resources	0.0	-	0.0	-
Corporate Allocations	7.7	14.0%	14.7	17.9%
Contribution Margin	($1.2)	(84.8%)	($9.9)	(39.8%)
% of Net Revenue	-12%		-84%	
Average Headcount	80	4.8%	75	5.1%
People costs per head	134,200	5.4%	130,720	8.9%
Infrastructure costs per head	29,750	13.8%	30,400	15.0%

PUBLIC NETWORK SALES HIGHLIGHTS

- Public Network Sales (PNS) had a very strong quarter with revenues in excess of $10 million. This exceeded Q97-2 plan by 50% and brought PNS within 5% of the mid year revenue plan of $12 million. MSN Access revenues were $8 million for Q97-2 with Program revenues from ISDN and MS Commercial Internet System (formerly known as Normandy) making up the rest. Costs of revenue are expected to be defined and recorded into this channel by the end of the year. Currently they are included in other channels' costs including MSN.
- Referral Server Program momentum continues with 55 contracts signed worldwide at the end of December. This represents better than an 80% growth from Q97-1 deals with explosive growth in the Far East and Europe who now have 21 and 14 signed deals, respectively. Referral Server wins in key accounts such as AT&T, BT, EUNet, MCI, Netcom, Prodigy, Sony, Sprynet, CompuServe, Tokyo Internet and UUNet – good news for continued improvement in IE market share. The number of hits on the Referral Server in late Q97-1 were approximately 3,000 per day, but are up to average rates of 10,000 per day with some peak days of 20,000 by the end of December.
- Controllable expenses were about 30% better than plan for the quarter and the year due to delayed hiring and execution on marketing plans. PNS is expected to make up for the low run-rate in marketing and PSS spend in the second half.
- PNS is bringing a steady stream of new business with non-traditional business models to MS. Currently there are approximately 75 special agreements which represent a 2 to 3 year commitment and present numerous distribution, pricing, operational support challenges to this evolving business. Staffing will also become an issue before fiscal year end.

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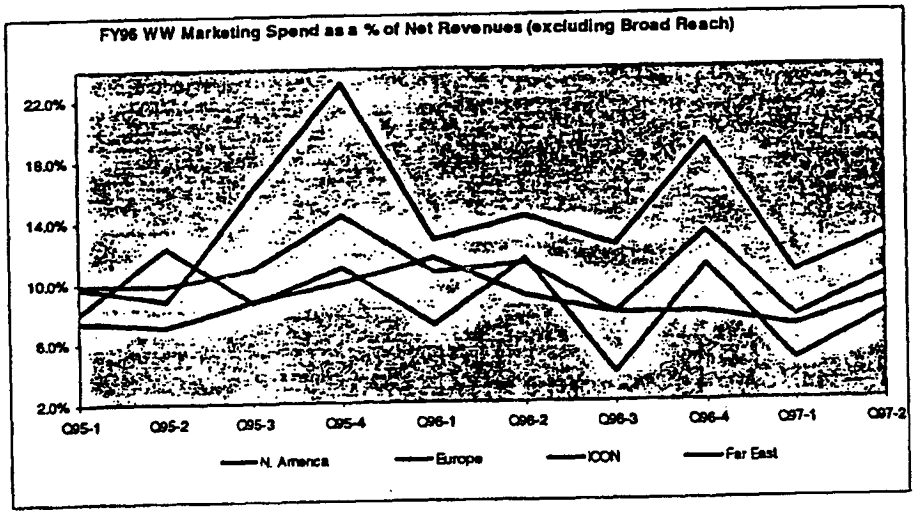
MARKETING EXPENSE REVIEW

Worldwide Net Marketing Spend by Region
U.S. Dollars (in millions)

	Q95-1	Q95-2	Q95-3	Q95-4	Q96-1	Q96-2	Q96-3	Q96-4	Q97-1	Q97-2
North America	$42.8	$45.3	$68.7	$105.2	$86.4	$96.2	$74.3	$146.6	$85.7	$117.5
Europe	25.0	45.0	46.2	50.1	49.6	69.7	44.3	61.8	33.2	76.1
ICON	6.6	7.4	8.5	11.4	16.4	11.6	9.8	15.3	10.6	17.5
Far East	7.7	13.3	11.9	19.7	11.3	24.7	10.9	31.4	11.6	21.6
Finished Goods Total	$82.1	$111.0	$135.4	$186.4	$163.7	$202.1	$139.4	$255.0	$141.1	$232.8
Year over year increase/(decrease)			59%	31%	99%	82%	3%	37%	-14%	15%
WW Broad Reach	3.6	38.6	34.2	24.4	54.7	54.9	18.7	47.2	23.2	28.9



- Net worldwide FG marketing expense for Q97-2 was $233 million, 5% below plan and represents a 15% increase over Q96-2. Year to date marketing spend was $374M, 9.8% of net revenue versus plan of 13.7%.
- Q97-2 spending increased by $92 million from Q97-1 and as FY97 marketing programs ramp up and spend increases for the holiday season.
- Year to date marketing spend was 83% of budget and represented 43% of the full FY97 plan.

($ in thousands)	December YTD Totals			FY97 YTD	
	Actual	Budget	% Budget Spent	Budget	% Budget Spent
N. America	$203,227	$260,771	77.9%	$483,539	42.0%
Europe	109,396	114,216	95.8%	229,390	47.7%
ICON	33,145	43,478	76.2%	81,557	40.6%
Far East	28,086	33,759	83.2%	68,442	41.0%
FG Total	$373,854	$452,224	82.7%	$862,928	43.3%
WW Broad Reach	$52,043	$55,450	93.9%	$110,900	46.9%

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MICROSOFT CONSULTING SERVICES

(in millions)	Q97-2			YTD FY97		
	Actual	Plan	Var %	Actual	Plan	Var
Consultant	$43.3	$41.1	5%	$71.6	$74.7	(4%)
Subcontractors	13.9	12.2	14%	31.1	22.2	40%
Sem/Training Fees	0.6	0.2	160%	0.9	0.5	77%
Net Revenues	57.8	53.6	8%	103.5	97.4	6%
People	27.6	32.1	14%	54.4	62.2	12%
Infrastructure	6.6	7.3	9%	12.8	14.0	9%
Subcontractors	13.3	8.2	(63%)	23.2	15.3	(52%)
Other	0.5	1.0	46%	1.2	1.9	36%
Expenses	48.1	48.6	1%	91.7	93.4	2%
Responsibility Margin	9.8	4.9	98%	11.9	4.0	197%
Headquarter Allocations	2.3	3.0	24%	4.7	6.0	21%
Estimated G&A	1.8	1.8	0%	3.6	3.6	0%
Contribution Margin	$5.7	$0.2	nm	$3.6	($5.6)	nm
MCS Practice Headcount	1,055	1,156	9%	1,025	1,116	8%
MCS Headquarters Headcount	25	33	24%	25	33	24%
Practice Revenue/Head	$164,118	$142,284	(15%)	$139,756	$133,833	(4%)
Practice Expenses/Head	$131,791	$139,955	6%	$133,555	$140,004	5%
(annualized per average head)						

BUSINESS INITIATIVES

- Ten more Enterprise Program Managers (EPMs) were hired in the second quarter bringing the total number to 85 worldwide. EPMs assisted in the deployment and architecture of MS products in successful engagements including Barclays Bank, Nat West Bank, Allstate Insurance and MCI. A new program was implemented based on the EPM concept targeted towards Large Account Resellers. The first account was Ameridata, where 8 EPMs assist Ameridata customers with strategy, requirements definition and implementation of MS solutions.
- MCS UK has partnered with Digital to develop an add-on to NT 4.0 that provides the security extensions needed to meet the UK government's requirements for authentication. With this enhancement NT can be sold to the public sector. This initiative will enable the potential sale of more than 400,000 copies of NT Workstation over the next two years.

BUSINESS RESULTS

- Q97-2 net revenues exceeded plan by $4 million. Of the $58 million in revenue. 63% was generated in North America, 29% in Europe, 6% in ICON and 2% in Far East. Subcontractor revenue was $2 million above plan for Q97-2 and represented 24% of total revenue.
- Q97-2 contribution margin was $6 million. With operating expenses about even with plan, higher than plan revenue in North America and Europe contributed to the improved margin. People costs remain lower than plan, offset by higher than plan subcontractor expense, as hiring continues to lag budgeted levels.
- Worldwide MCS headcount has grown to over 1,000 heads representing 48% growth over prior year but is about 10% below plan.

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PRODUCT SUPPORT

GROSS PSS COST AND PSS REVENUE FOR FINISHED GOODS CHANNEL

(in millions)	Q97-2						FYTD97					
	Actual			Plan			Actual			Plan		
	PSS Cost	PSS Rev	Recov %	PSS Cost	PSS Rev	Recov %	PSS Cost	PSS Rev	Recov %	PSS Cost	PSS Rev	Recov %
North America FG	$72.9	$19.3	27%	$81.2	$23.3	29%	$142.3	$38.7	27%	$162.8	$43.4	27%
Europe FG	30.7	15.8	51%	34.5	12.1	35%	59.6	23.3	39%	68.9	21.4	31%
ICON FG	7.2	2.4	34%	7.7	1.6	21%	13.8	4.0	29%	15.4	3.1	20%
Far East FG	13.4	3.5	26%	14.0	3.3	23%	26.5	6.1	23%	28.9	6.0	21%
Total FG	$124.2	$41.3	33%	$137.4	$40.3	29%	$242.2	$72.1	30%	$278.0	$73.9	27%

NET PSS COST AS A PERCENTAGE OF FINISHED GOODS CHANNEL REVENUE

(in millions)	Q97-2				FYTD97			
	Actual		Plan		Actual		Plan	
	PSS Cost	Cost/Rev %	PSS Cost	Cost/Rev %	PSS Cost	Cost/Rev %	PSS Cost	Cost/Rev %
Interactive Media	$3.8	1.9%	$3.9	1.8%	$6.7	2.4%	$7.8	2.7%
Desktop Applications	32.2	2.8%	40.5	3.9%	63.0	3.0%	82.0	4.3%
Desktop Systems	19.7	6.0%	25.6	12.3%	48.1	8.2%	51.8	14.3%
Internet Platform & Tools	15.7	14.6%	13.8	11.5%	26.0	11.3%	28.7	13.7%
Business Systems	11.8	3.3%	13.4	4.7%	26.2	4.0%	31.7	6.1%
Total Net Cost	$83.2	3.9%	$97.1	5.2%	$170.0	3.9%	$202.1	5.2%

Business Highlights

- Q97-2 net FG support costs totaled $83 million, 14% below plan and 3.9% of net FG revenue compared to plan of 5.2%. In addition, net costs were down $44 million over Q96-2 primarily due to prior year support costs for Windows 95 and increased Technical Support revenue this quarter.
- Gross support costs totaled $124 million and were 9.6% below plan in Q97-2 largely due to less people resources driven by lower than plan incidents.
- During Q97-2, support revenues were slightly above plan and totaled $41 million, a growth of 51% over Q96-2. The favorable support revenues were driven by strong sales in the Priority contract and pay-per-incident offerings. Due to the increase in call waiting times related to Windows 95 demand, customers chose to call into the pay-per-incident line, which resulted in an increase in revenue during this quarter. Additional 180 temporary resources were added to Desktop Systems Support in the United States to handle the increased demand resulting from the surge in Windows 95 sales.
- Q97-2 Net Support costs were below plan across all regions. The North America and Europe regions comprised the majority of net support costs and had below plan costs of $4 and $8 million, respectively. North America was below plan primarily due to lower than plan incidents. Europe's net costs were below plan due to a combination of higher support revenues and lower free support costs.
- Lower than plan incidents per unit across the support organization are due to a number of factors including new support policies lowering the number of incidents supported, actual product sales mix, product improvements, and improved support methods. For example, the United States support recently launched twenty Troubleshooting Wizards for customers to get help quickly and easily.
- While incidents per unit continued to decline, Premier Technical Support customer satisfaction has increased. Domestic Premier customer satisfaction increased to a record 74% very satisfied. The key drivers were responsiveness and the value that Technical Account Managers added to customers in the planning of MS Product deployments.

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PRESS

(in thousands)	Q97-2 Actuals	Q97-2 % Plan	Q97-2 % NetRev	FYTD 97 Actuals	FYTD 97 % Plan	FYTD 97 % NetRev
Net Revenue	$ 31,437	121%	100.0%	$ 50,834	121%	100.0%
Cost of Revenue	11,423	99%	36.3%	17,873	89%	34.4%
Gross Margin	20,014	139%	63.7%	32,961	150%	65.6%
Operating Expenses						
G&A Costs	80	23%	0.3%	128	98%	0.2%
Infrastructure	709	98%	2.3%	1,139	82%	2.2%
Marketing Spend	2,368	72%	7.5%	3,492	59%	6.7%
Other Misc Expenses	358	49%	1.1%	842	66%	1.6%
People	1,942	87%	6.2%	3,392	78%	6.5%
Operating Expenses	5,457	78%	17.4%	8,993	69%	17.3%
Responsibility Margin	14,556	199%	46.3%	23,968	268%	48.2%
Corporate Allocations	4,759	83%	15.1%	8,368	75%	16.1%
Contribution Margin	$ 9,797	624%	31.2%	$ 15,599	703%	32.1%

- Net revenue for Q97-2 was $31 million, $6 million (21%) ahead of plan. Costs and expenses were in line with plan resulting in a contribution margin of $9.8 million. Without the reversal of $4 million in reserves in Q97-2 the contribution margin would have been $5.6 million, 26% over plan. These above plan results were achieved without Office 97 titles, which were budgeted to ship in November.

- As the table below illustrates, the top selling titles for Q97-2 are based on Windows NT and Windows 95. As expected, Windows NT 4.0 related titles went from approximately 20th in Q97-1 to the top selling title for Q97-2. Window NT 3.51 related titles continue to sell in the top 10 and Windows 95 Resource Kit is the 5th top selling title for Q97-2. For the top 10 titles, revenue per unit has doubled to $54.16 per unit from $26.34 same quarter last year.

Top 10 Titles Q97-2

(revenue in millions)

No.	Part Description	Op System	Revenue	% of Rev.	Units	Rev/Unit
1	WIN NT SERVER RESOURCE KIT	Win NT	$3,972	20.63%	52,479	$75.69
2	ME WIN NT WSTN RESOURCE	Win NT	2,637	13.70%	76,648	34.41
3	MICROSOFT SQL SERVER	Multiple	1,878	9.76%	17,344	108.31
4	SUPPORTING WINDOWS 95 TRAINING KIT	Windows 95	1,074	5.58%	11,102	96.70
5	WINDOWS 95 RESOURCE KIT	Windows 95	974	5.06%	40,446	24.08
6	NETWORKING FUNDAMENTALS KIT	Multiple	913	4.74%	17,697	51.57
7	BACKOFFICE RESOURCE KIT I	Multiple	688	3.57%	16,258	42.29
8	MICROSOFT INTERNET INFO	Multiple	630	3.27%	11,714	53.75
9	WIN NT TRAINING KIT VER 3.51	Win NT 3.51	593	3.08%	6,026	98.45
10	WIN NT RESOUCE KIT 3.51(5-VOL KIT)	Win NT 3.51	453	2.35%	5,315	85.24
	Total Q97-2 Top 10 Titles:		$13,812	71.75%	255,029	$54.16

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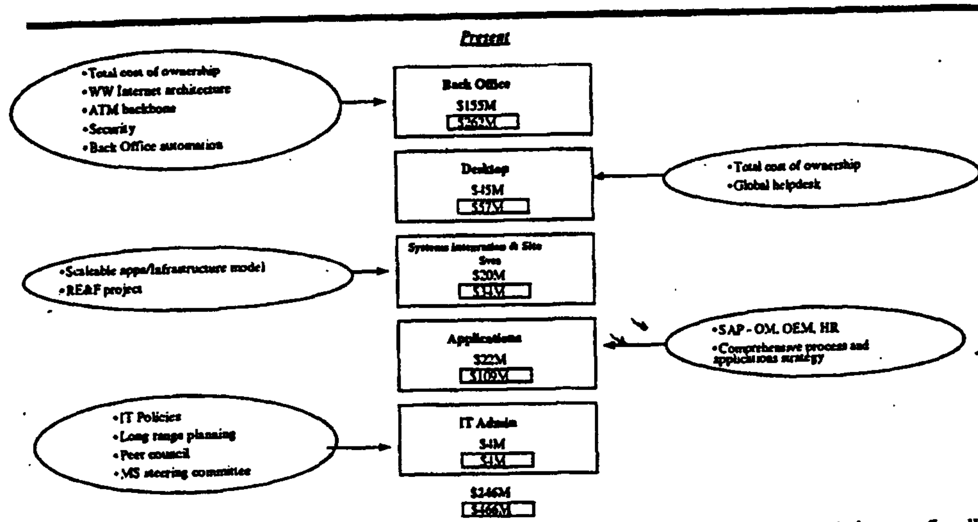
GENERAL & ADMINISTRATIVE

- Total general and administrative costs include functional corporate cost centers that support MS on a worldwide basis such as finance. legal services. and IT project development. Expenses such as employee benefits. facilities costs. infrastructure operation. and adminisrrative services.are distributed to domestic product, sales. and administrative groups.
- For internal management reports. the remaining net corporate G&A costs are allocated to the channels and product groups as part of corporate allocations.
- See G&A definitions included in the Appendix.

INFORMATION TECHNOLOGY

- Significant progress has continued during Q97-2 toward the initiatives and cost saving actions identified below. The Corporate ITG portion of WWIT has spent almost $20 million less than budget through the first half of the fiscal year. Further organizational tweaks have taken place including combining the elements responsible for WW end user services under new General Manager Vijay Vashee.

Major Initiatives



Microsoft Corporate IT major initiatives by reorganized IT business units. Dollar amounts in boxes reflect WW IT costs both within and outside of Corporate IT; amounts above that represent Corporate IT costs included in WW IT costs.

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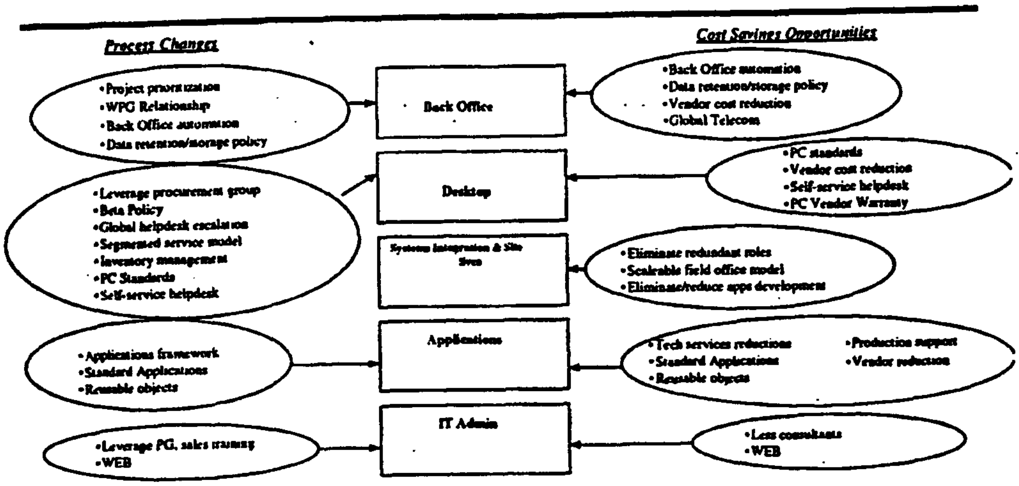
Process Changes and Cost Savings Ideas



- Process changes listed represent a new focus on tactical steps to achieve Corporate ITG objectives. The cost savings listed are expected to achieve $40 million in cost reductions in WW IT spending, $20 million of which are controllable by Corporate ITG.

- The development of a business model that more clearly represents the worldwide costs and activities of IT at Microsoft continues to evolve. Work on the model during the second quarter included detail presentations to the Executive Committee in December on elements within the Backoffice area including operations costs related to NT, SQL, and Exchange. Q97-3 work will finish identifying drivers of various IT costs and build a consumption view of IT as well as a driver based planning model that will be used for FY98 planning. A TCO view of our desktop area will be presented to the Executive Committee in February.

- Work also continues on the consolidation of WW Web datacenter operations from MSN to Corporate IT.

REAL ESTATE & CONSTRUCTION

Worldwide Facility Distribution & Capital Spending

($ in millions, square feet in thousands)

	Facilities Distribution		Q97-2 Capital Spend			FYTD97 Capital Spend		
Location	Square Feet	Mix	Actual	Plan	Variance	Actual	Plan	Variance
Puget Sound	4,132	55%	$59.6	$84.1	$24.6	$114.0	$143.5	$29.5
Other Domestic	1,363	18%	2.3	11.9	9.5	4.9	15.1	10.2
International	2,004	27%	17.8	3.3	(14.4)	34.7	24.3	(10.4)
	7,499	100%	$79.6	$99.3	$19.7	$153.6	$182.9	$29.3

- Worldwide space capacity as of December 31, 1996 was approximately 7.5 million square feet.

- Construction of Buildings 30, 31, and 32 (Pebble Beach) on the northeast corner of the Campus continued during the quarter and the buildings are expected to be occupied in Q97-3. The

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buildings will add 365,000 square feet to the portfolio and capacity for 1,500 people. The total cost of this project is $116 million.

- Site work on the Augusta project, located between Building 22 adjacent to SR 520 and the southwest section of the main campus, continued during the quarter. By Q98-3, this $184 million dollar project will add 566,000 square feet to the portfolio and capacity for 2,300 people. Additionally, a building permit for the Troon project has been obtained but work will not commence until space is needed and final approval is obtained. Troon will be located next to Augusta and will add 415,000 square feet to the portfolio and capacity for 1,700 people.

- Building 28, adjacent to Buildings 26 and 27 in the southwest section of Campus, will cost approximately $31 million, adding approximately 100,000 square feet to the portfolio and capacity for 470 people. Site work began in October 1996.

- Construction of the Thames Valley Park project in the UK continued during the quarter. Total construction cost at completion is expected to be $49 million. Although a proper CER was authorized, there is no FY97 capital budget for this project, which will drive an unfavorable variance by year-end.

- Improvements were completed on the Canyon Park Data Center in October 1996. This leased 32,000 square feet building will provide server and telephone expansion for Corporate IT. Premises are currently being commissioned by ITG. Total cost of this project excluding Corporate IT equipment is $24 million.

- Improvements for MS Studio continued during the quarter. Completion is expected in Q97-3 and total costs are estimated at $22 million. Microsoft purchased this property in January 1997 for $4.1 million.

Puget Sound Capital Spending

	YTD Actual	YTD Plan	Variance
Committed projects	$ 100.9	$ 121.4	$ 20.5
Tenant improvements	7.3	8.1	0.8
New construction	1.4	4.1	2.7
All other	4.4	9.9	5.5
Total	$ 114.0	$ 143.5	$ 29.5

- Committed projects include Pebble Beach, Augusta and the Canyon Park Data Center. Capital spend on tenant improvements represent work on existing buildings and new construction represents Campus projects expected to occur through FY98. The variance in spending for committed projects vs. plan is primarily due to the later than planned commencement of construction of Building 28 and Augusta. When completed, Pebble Beach, Augusta, Troon, and Building 28 will add over 1.5 million square feet of office space to the existing Campus.

- Effective October 1996, Real Estate and Facilities assumed management responsibilities for certain groups that are a portion of the corporate services distribution. These groups include Mail, Copy, Food Services, Reception Services and Audio Visual Technical.

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SUMMARY OF DISTRIBUTED G&A COSTS

(In $thousands)	Q97-2				YTD			
	Actual	Budget	Variance	%	Actual	Budget	Variance	%
ITG								
Depreciation	12,857	18,407	5,550	30.2%	24,898	34,163	9,265	27.1%
Maintenance & Repairs	2,902	2,678	(224)	-8.4%	4,765	6,241	1,476	23.7%
Telecommunications	5,820	6,661	841	12.6%	11,671	13,172	1,501	11.4%
Contract & temporary labor	3,726	3,202	(524)	-16.4%	6,703	6,645	(58)	-0.9%
Payroll & taxes	4,375	4,226	(149)	-3.5%	8,724	8,664	(60)	-0.7%
Outsourcing	7,976	8,184	208	2.5%	16,021	16,583	562	3.4%
Other	2,097	2,768	671	24.3%	3,818	5,362	1,544	28.8%
	39,752	46,126	6,374	13.8%	76,600	90,830	14,230	15.7%
Human Resources								
Health benefits	15,428	18,281	2,853	15.6%	29,407	36,323	6,916	19.0%
401 (k) match	4,396	4,932	536	10.9%	9,740	9,926	186	1.9%
Health clubs	1,694	1,800	106	5.9%	3,381	3,577	196	5.5%
Other	3,220	3,864	644	16.7%	7,045	7,739	694	9.0%
	24,738	28,877	4,139	14.3%	49,573	57,565	7,992	13.9%
Employee Services								
Copy center	1,896	2,925	1,029	35.2%	3,853	5,802	1,949	33.6%
Information services	2,813	3,073	260	8.5%	5,925	6,105	180	2.9%
Food & beverages	2,750	2,320	(430)	-18.5%	5,243	4,608	(635)	-13.8%
Mail center	2,465	2,232	(233)	-10.4%	4,406	4,593	187	4.1%
Company store	(1,577)	(1,628)	(51)	3.1%	(2,556)	(2,708)	(152)	5.6%
Other	2,262	2,788	526	18.9%	4,683	6,550	1,867	28.5%
	10,609	11,710	1,101	9.4%	21,554	24,950	3,396	13.6%
Real Estate								
Building Services	4,167	3,813	(354)	-9.3%	7,756	8,087	331	4.1%
Rent & Utilities	7,120	7,982	862	10.8%	13,780	15,367	1,587	10.3%
Depreciation	9,431	8,585	(846)	-9.9%	18,198	16,849	(1,349)	-8.0%
Maintenance & repairs	2,278	2,217	(61)	-2.8%	4,306	4,539	233	5.1%
Supplies & equipment	937	1,347	410	30.4%	2,396	2,946	550	18.7%
Other	1003	406	(597)	-147.0%	476	1,102	626	56.8%
	24,936	24,350	(586)	-2.4%	46,912	48,890	1,978	4.0%
Total	$ 100,035	$ 111,063	$ 11,028	9.9%	$ 194,639	$ 222,235	$ 27,596	12.4%

- Distribution costs are categorized as service costs where the distributing group controls the unit cost and the receiving business unit drives unit consumption. For example. Employee Services manages benefit costs per person. but company headcount and their covered dependents drive total benefit costs. Costs are distributed only to US based groups.
- Distributed ITG infrastructure expenses were under plan in Q97-2 primarily due to $5.5 million lower depreciation and amortization expense with actual capitalized purchases lagging plan.
- Distributed employee benefit costs were significantly under plan in Q97-2 primarily from lower than planned recruiting costs and healthcare costs resulting from a lag in total employee headcount against plan.
- Distributed corporate services costs were under plan for Q97-2. The two biggest plan underruns were in the copy center. User demand and unit costs were both below plan. The negative amounts in the company store and travel represent the impact of store profits and travel rebates, respectively.
- Distributed facilities costs were about 90% of plan primarily due to lower than planned housed headcount. The costs associated with the Puget Sound area winter storms at the very end of the calendar year will impact Q97-3 expenses.

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CAPITAL MARKET ACTIVITIES

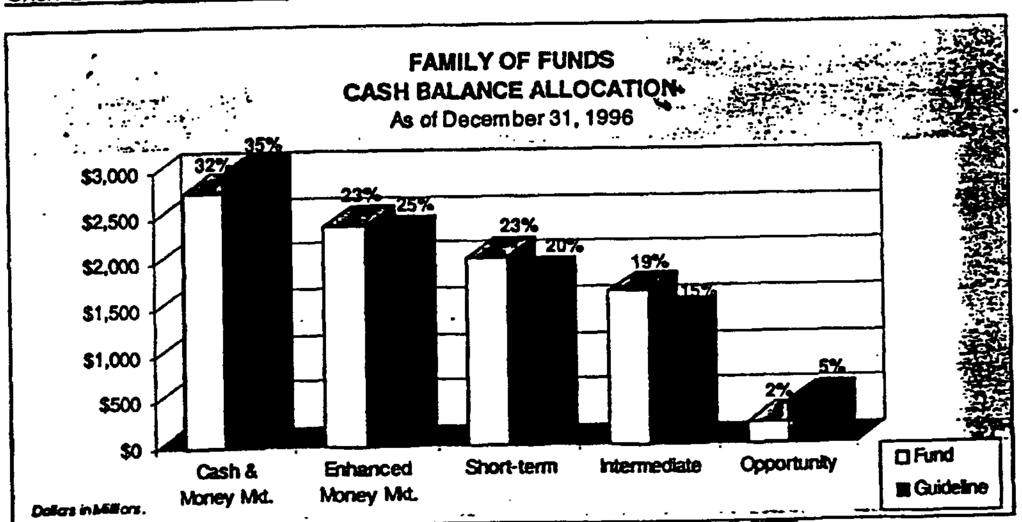
PORTFOLIO MANAGEMENT - FAMILY OF FUNDS

	Cash & Money Mkt	Enhanced Money Mkt	Short Term	Intermediate	Opportunity	Total
Portfolio Allocation:						
Q97-1	34%	24%	22%	17%	3%	100%
Q97-2	30%	26%	22%	18%	2%	100%
Cash Balances (in millions) *						
Q97-1	2,337	1,659	1,539	1,185	191	6,912
Q97-2	2,782	2,404	2,048	1,660	226	9,120
Total Rate of Return (Pre-tax) **:						
Q97-1	6.01%	6.05%	9.44%	9.87%	7.52%	7.52%
Q97-2	6.30%	6.64%	9.95%	12.16%	5.59%	8.12%

*Market values plus accrued income, including open trades, but not including foreign currency balances. These total balances represents the "risk" position of the portfolio.
**Annualized data is provided for illustrative purposes. Past performance is not a predictor of future results.

- Q97-2 portfolio economic income corresponded to $.07 per share on an after-tax basis. This contribution represents a cash flow of $104 million from interest income net of realized gains and losses, plus the value of tax-related and unrealized net gains in market value of $28 million. Unrealized gains and losses are reflected in equity and do not flow through the P&L until realization.
- Q97-2 Family of Funds allocations and cash balances exhibited an increased emphasis on longer duration funds as shown in the Allocation chart below.
- The Q97-2 total rate of return vs. Q97-1 increased 60 basis points to 8.12%, reflecting a favorable decrease in interest rates. Annualized performance is depicted in the performance chart that follows.

CASH BALANCE ALLOCATION



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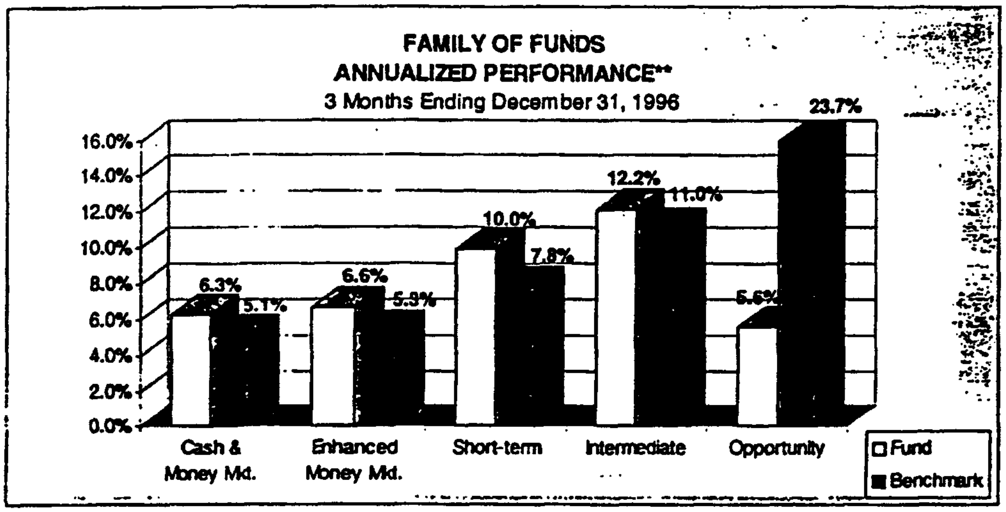
FUNDS PERFORMANCE



- Continued abatement in the strength of economic indicators during Q97-2 led the Federal Reserve to leave short-term rates unchanged; the market, which had been expecting an increase, correspondingly moved to prices discounting little to no probability of future Fed rate increases.
- Market interest rates matching the maturities of the MS Family of Funds reflected a "twist" in the yield curve which occurred during the quarter. Six month US Treasury Bill yields rose by 5 basis points to 5.3%, while three year US T-Note yields fell 25 basis points to 6.0%. and five year US T-Note yields fell 25 basis points to 6.2%.
- Portfolio durations were positioned close to equivalent fund benchmark durations. Funds 1 through 4 were at 97%, 103%, 101% and 99% of their respective benchmarks, on average, during the quarter.
- The four Family of Funds portfolio returns exceeded their respective benchmarks for the quarter by a weighted-average of 102 basis points (on an annualized basis). Portfolio returns above benchmarks were primarily generated via security sector and issue selection.
- The Strategic Opportunity Portfolio, which represents about 2% of the total portfolio, delivered an annualized return of 5.6% during the quarter. Credit spread widening in media, cable and entertainment holdings were responsible for fund's under performance.

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ACCOUNTS RECEIVABLE

WORLDWIDE ACCOUNTS RECEIVABLE

(in millions)

	DSO				Aging Summary				
	Q96-3	Q96-4	Q97-1	Q97-2	Total	Current	1-30	31-60	60+
Finished Goods									
North America	53	34	39	41	$465	329	87	24	25
Europe	59	43	43	42	369	296	52	11	10
Far East	60	45	64	72	236	203	25	7	1
AMME	80	68	69	82	30	25	4	1	0
Brazil	219	138	188	119	39	27	6	(1)	7
India	223	148	100	151	9	5	3	1	0
Southeast Asia	98	91	96	94	28	20	3	2	3
South Pacific	200	137	137	128	80	64	5	2	9
Spanish America	72	92	104	98	61	52	6	1	2
Total Finished Goods	65	48	50	51	1,317	1,021	191	48	57
OEM	19	19	24	30	330	227	61	23	19
Other					84	50	12	5	17
Total accounts receivable	51	40	46	47	$1,731	$1,298	$264	$76	$93
						75%	5%	4%	5%
Clearing Acounts					(154)				
Reserves for sales returns					(656)				
Allowance for doubtful accounts					(229)				
Reserves - Other					(55)				
Earned, unbilled revenues					338				
Accounts receivable-net					$975				

- Worldwide gross accounts receivables increased from $1.26 billion at the end of Q97-1 to $1.73 billion at the end of Q97-2. This increase is coupled with deterioration in aging from 82% current to 75%. However, $114 million ($66 million for North America and $48 million for Japan) was received shortly after the close of the books.
- Worldwide DSO increased from 46 days in Q97-1 to 47 days in the current quarter with deterioration primarily in the Far East, AMME and North America.
- Reserves for sales returns increased from $499 million at Q97-1 to $656 million for the present quarter and allowance for doubtful accounts increased from $204 million at Q97-1 to $229 million at the end of Q97-2.
- Solaris, the Brazilian Distributor, was unsuccessful in securing financial support and consequently has defaulted on payment to Microsoft totaling $5.2 million. This entire amount was written off as bad debt in the second quarter, however, Solaris has not filed for court protection and our local subsidiary is attempting to reach a favorable settlement.

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ACCOUNTS RECEIVABLE OF THE TEN LARGEST CUSTOMERS WORLDWIDE

(in millions)

	Total		Aging Summary			
	Balance	Percent	Current	1-30	31-60	Over 60
Ingram Micro	$187	11%	$173	$13	$1	$0
CHS	65	4%	50	13	1	1
Stream International	63	4%	28	19	10	6
Tech Pacific	60	3%	50	3	2	5
Computer 2000	50	3%	45	4	1	0
GT Interactive Software	50	3%	45	4	0	1
Softbank	47	3%	43	2	2	0
Tech Data	39	2%	32	6	0	1
Software Spectrum	37	2%	27	6	2	2
Digital Equipment	32	2%	14	6	10	2
Total ten largest	630	36%	507	76	29	18
Other	1,101	64%	791	188	47	75
Total Q97-2	$1,731	100%	$1,298	$264	$76	$93
Total Q97-1	$1,260		$1,036	$102	$43	$79
Aging mix of top ten			80%	12%	5%	3%
Aging mix of total			75%	15%	4%	5%
Q97-1 Aging mix of total			82%	8%	3%	6%

- Total accounts receivable for the top ten worldwide customers accounted for 36% of the total at the end of Q97-2, unchanged from 36% at the end of Q97-1.
- Merisel continues to show signs of financial weakness, having posted net losses in each of the last three consecutive quarters of 1996. Merisel's latest loss totaled $117 million for period ending September 30, 1996 and the ongoing financial deterioration has eroded its tangible net worth to a deficit of $31 million. This account, with a balance of $32 million as of December 1996, is closely monitored and alternative forms of financing are being investigated to mitigate the credit risk.
- Microsoft's largest customer, Ingram Micro, successfully completed its IPO on November 1, 1996. Ingram sold 16% of the company or 23 million shares at a market value of $18 a share yielding net proceeds of $392 million. The IPO reduced its debt to equity ratio from 8 to 1 to 3 to 1. Ingram's market capitalization now exceeds $3 billion.
- At the end of the second quarter, Stream International dropped to being the third largest single customer behind CHS. RR Donnelley has stated that it is exploring ways to sell the business piece by piece. Stream's combined losses over the last two years has totaled approximately $75 million with expectations of 1996 revenue dropping below last years' revenue of $1.5 billion. MS is discussing the possibility of securing a "Right of Offset" agreement with their senior management. This agreement would give MS the right to offset Stream's outstanding balance against any monies owed to RR Donnelley.

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EQUITY INVESTMENTS & OTHER ASSESTS

(in millions)

	Cost Q97-2	Cost Q97-1	Cost Change	Market Value(if public) Q97-2	Market Value(if public) Q97-1	Market Value(if public) Change
Equity investments						
Wang	$82	$83	(1)	--	--	--
Stac Inc.	38	38	--	29	36	(6)
Mtel	30	56	(26)	15 (b)	28 (b)	(13)
Santa Cruz Operation	20	20	--	30	28	2
UUNet/MFS/WorldCom	16	16	--	405	323	82
MicroUnity	15	15	--	--	--	--
Lightspan	12	12	--	--	--	--
Individual	11	11	--	6	12	(5)
Verisign	7	--	7	--	--	
Metricom	6	6	--	3	4	(1)
Tandem	6	6	--	--	--	--
Academic Systems	5	5	--	--	--	--
WebTV	5	5	--	--	--	--
Single Trac	5	5	(0)	--	--	--
VDONet	5	--	5	--	--	--
Proginet	2	--	2	--	--	--
Citrix Systems	2	2	--	64	84	(21)
Helicon	1	1	--	--	--	--
ASCII NT	1	1	--	--	--	--
Monotype	1	1	--	--	--	--
Vanstar	--	--	--	38	38	0
DreamWorks	--	1	(1)	--	--	--
MSNBC	--	26	(26)	--	--	--
TCI	--	125	(125)	--	123 (a)	(123)
	270	435	(40)	$590	$674	($84)
Other equity investments	378	372	6			
Mark-to-market (net of taxes)	245	175	70			
Valuation allowance	(89)	(86)	(3)			
Equity Investments	804	896	33			
Other assets						
Intellectual property rights	287	265	22			
Accumulated amortization	(205)	(102)	(103)			
L/T Loans & Other	136	145	(9)			
Total other assets	218	308	(90)			

a) Valuation included 1,388,888 shares of Liberty Media.
b) Excludes MS's 1.4 million warrants in Mtel, 1.1 million of which have certain performance requirements, with an estimated current market value in excess of $5 million.

- TCI (and Liberty Media) shares were returned to TCI, in compensation for the 20% of MSN that TCI held.
- Three new minority investments were made during Q97-2; Verisign, VDONet and Proginet, for $6.5 million, $5 million and $2.4 million, respectively.
- In addition to the reclassification of Mtel's bonds ($26 million), other equity investments (net) increased $6 million, primarily due to an additional investment in SKG for $8 million.
- Total market value of investments in public companies decreased $84 million during the quarter primarily due to the retirement of the TCI and Liberty Media shares (-$123 million), coupled with an increase in the stock price of UUNet/MFS (+ $82 million), and a decrease of the Citix stock (-$21 million).

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- Intellectual property rights increased $22 million during the quarter with the investments in ResNova ($1.5 million), Panorama ($12.75 million), as well as additional investments in Eshop ($2 million) and Netwise ($5.2 million). Accumulated amortization increased by $103 million, primarily due to a specific reserve for the HP patent cross-license ($60 million).
- Long term loans and other decreased by $9 million, loans to UUNet decreased by $3.3 million, and we loaned $2.6 million to Tech Data to incent them to enter the Brazilian market.

HIGHLIGHTS OF CURRENT INVESTMENTS

(See Appendix for additional details)

- TCI and MS ended their relationship regarding MSN. MS will return its TCI and Liberty Media shares to TCI, in exchange for the 20% of MSN that TCI held.
- On January 2, 1997, WorldCom completed its merger with MFS, and each MFS share was converted to 2.1 WorldCom shares. MS now holds 15.5 million shares of WorldCom, or 2.2%, worth $415 million as of January 10th, 1997. MS' ownership derives from its investment in UUNet, which was acquired by MFS on August 12, 1996.
- SCO sent Microsoft a letter in which they want "out" of the 1987 "Centaur" Agreement (originally entered into between MS and AT&T). SCO claims that there is no longer any legitimate business reason to maintain binary compatibility and therefore, to continue to pay royalties to MS, and that any MS insistence on keeping the Agreement in force is anticompetitive/antitrust violation. The companies are currently discussing and Scott MacGregor, SCO Senior VP for Products was in Redmond in January 14, 1997.
- MU closed its fab on July 2, sold it to Interconnect for $11 million in cash and the assumption of the $17 million lease
- Individual acquired the assets of Hoover Business Intelligence for $2 million, and sold its Bookwire division to Cahners for $1 million. As of January 10, Individual's share price had fallen to $6.125 from the March IPO of $14.
- Lightspan raised an additional $20 million in September 1996 which included $1.8 million from Microsoft. Delays in the delivery of Sony titles caused Lightspan to revise its CY97 revenue goals down, from $12 million to $7 million. They expect to run out of cash in April 97 and raise money through a private placement.
- Academic Systems signed a $3.5 million contract licensing Jostens Learning Corporate to distribute and support Interactive Mathematics materials. It has installed its IM software on 41 college campuses as of December 31, 1996.
- VDONet announced on November 6th that US West and other investors would invest $7 million in the company, at a price of $9.45 per share, compared to the $3.84 per share at which MS invested $5 million on October 28.
- Helicon revenues of $2.8 million for the first 7 months exceeded expectations and permitted additional to complete their financing resulting in a reduction of MS' ownership from 48% to 40%.
- Vanstar, as of November 30 had hired 303 systems engineers and 193 of them had achieved MCSE status.

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NEW DEALS

PANORAMA SOFTWARE SYSTEM LTD.

- On October 22, 1996 Microsoft acquired multidimensional Online Analytical Processing (OLAP) technology from Panorama Software Systems of Tel Aviv, Israel. The cash purchase price was $12.75 million.
- Panorama's technology is based on a three-tier multidimensional architecture designed to support online analytical processing, enterprise information systems and decision support applications. OLAP capabilities will be added natively to Microsoft BackOffice and SQL Server.
- Microsoft hired Panorama's six engineers who relocated to Redmond on January 6, 1997.
- Microsoft and Panorama also entered into a consulting agreement costing $1 million over three years.

NETCARTA CORPORATION

- On December 10, 1996 Microsoft announced the acquisition of NetCarta Corporation for $20 million in cash.
- Based in Scotts Valley, CA, NetCarta develops and markets WebMapper, a Web-site management tool which provides comprehensive site visualization, content analysis, link management and reporting capabilities for Web servers. Microsoft will integrate WebMapper into the Microsoft BackOffice product line.
- Microsoft will hire 9 NetCarta employees who will relocate to Redmond after the acquisition closes.
- The acquisition is expected to close in January 1997, pending the resolution of certain contractual issues between NetCarta and other third parties.
- CMG Information Services Inc. is a majority shareholder in NetCarta. Microsoft will acquire a 4.9% equity stake in CMG for $7 million, and the companies will explore Internet-related business opportunities between Microsoft and CMG's other portfolio companies.

RESNOVA SOFTWARE

- On November 14, 1996, Microsoft acquired selected assets from ResNova Software, including WebForOne and Boulevard, for $1.5 million in cash. These Macintosh Web technologies will be incorporated into future versions of Internet Explorer browser for the Macintosh.
- Five ResNova employees joined Microsoft in the Internet Platforms and Tools Division in our San Jose office.

PROGINET CORPORATION

- On December 17, 1996, Microsoft sold its TransAccess assets, high performance middleware for integrating mainframe and client-server environments, to the Proginet Corporation in order to free up support and development resources. These are the assets that had been previously purchased from Netwise in October 1995. Microsoft is retaining the former Netwise employees. As part of the agreement, Microsoft retains a license to the TransAccess technology.
- Proginet is an approximately $40 million publicly traded company that develops communications software for linking mainframes to LANs in file transfer applications
- Microsoft received 100,000 shares of Proginet and will receive an additional $2.1 million worth of Proginet stock after 18 months from closing. Proginet assumed approximately $685,000 in current obligations to TransAccess customers and Microsoft may earn additional stock grants contingent on the future performance of TransAccess.
- The value of the deal based on Proginet's stock at closing is $3.1 million with the potential of earning an additional $4.4 million in contingency payments. This deal provides Microsoft with the right to approximately a 6.4% stake in Proginet (11.6% if the maximum contingency payment is earned).

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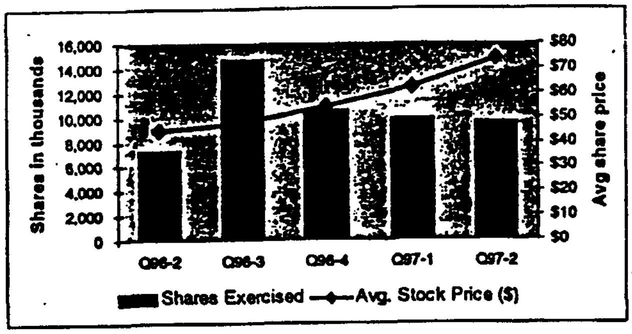
HEDGING ACTIVITIES

STOCK OPTIONS GRANTS AND EXERCISES



- MS stock traded at an average price of $74.04 during Q97-2. The highest closing price was $85.50 and the lowest closing price during the quarter was $66.06.
- In Q97-2 the number of stock option exercises was 6,517, an increase of 34% over the same period in FY96. The number of shares exercised was 9.6 million, a 33% increase from Q96-2.
- During Q97-2, 1,029 stock option grants were issued, totaling 11 million shares. Of this total, 1.2 million shares were dated in Q97-2, with the balance dated in prior quarters due to overlapping window periods and completion of the jumbo grant issuance.
- Cumulative outstanding options on 12/31/96 were 264 million with an average price of $28.97. Authorized but unissued options totaled 554 million.
- Under the ESPP program, a total of 584,158 shares for the period end 12/31/96 were issued to 11,028 domestic employees at a purchase price of $51.98 per share. International ESPP is reported in odd numbered quarters.

STOCK REPURCHASES

- During Q97-2, Microsoft purchased 5.1 million shares at an average price of $73.32. A total of 133.7 million shares have been purchased life-to-date at an average price of $31.10.

	Shares adjusted for all splits	Amount (millions)	Average Cost
FY90	7,141,500	$ 46	$6.53
FY91	21,879,000	197	$8.99
FY92	7,919,310	135	$17.04
FY93	12,514,000	250	$19.98
FY94	17,278,000	348	$20.12
FY95	23,338,000	698	$29.89
FY96	27,000,000	1,384	$51.26
Q97-1	11,588,000	729	$62.87
Q97-2	5,080,000	372	$73.32
Life to date	133,737,810	$4,159	$31.10

PUT WARRANTS

- At quarter end, 28 million put options were outstanding, with strike prices ranging from $60.50-$67.00 and a weighted average strike of $63.75. Maturities range from 6 to 18 months. Life-to-date program proceeds exceed $253 million, $27 million of which represent put options that have expired. Incremental premiums of $49 million were earned during Q97-2.
- This program has enhanced the buyback program by reducing life-to-date stock buyback cost per share by $1.89, from $31.10 to $29.21.
- In Q97-2, Microsoft added a net share settlement to its existing put warrant contract settlement methods. With this feature, Microsoft is no longer required to reflect a put warrant liability on the balance sheet. Had this change not been implemented, a liability of $1.8 billion would have been required as an offset to retained earnings. At the end of Q97-1, the accounting liability was $1.5 billion, but was reduced to $675 million via the purchase of "caps" which limited our downside risk.
- In Q97-2, Microsoft sold the first tranche of cash-only settled puts. These puts are only executed between reporting periods and the gain/loss from them are recognized as interest income but are non-taxable. Treasury sets "caps" on all these puts so that the maximum loss is predefined. In Q97-2, MS realized a $3.8m gain from the sale of cash-only settled puts.

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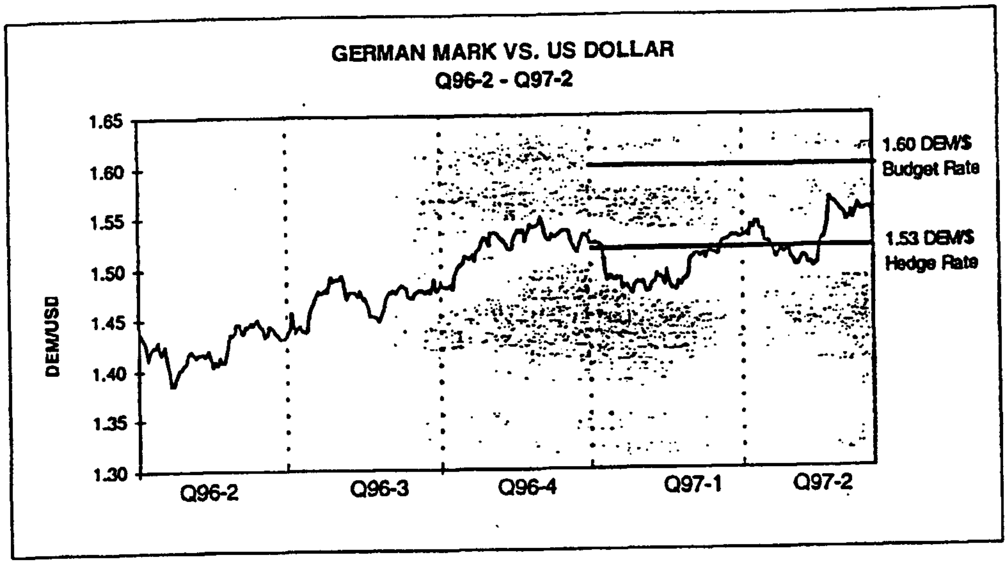
FOREIGN EXCHANGE HEDGING



- Even though the dollar traded in a relatively wide range during Q97-2, it strengthened only 1.3% versus the major European currencies. The dollar similarly strengthened versus the Japanese yen during Q97-2, trading between a range of 111Y/$ and 116Y/$.
- As of quarter end, the market value of MS' existing hedge for foreign currency denominated revenues equals a gain of $6 million. Initially, we bought foreign currency put options to hedge Microsoft's total forecasted FY97 exposure of $1.7 billion. The financial instruments used were average rate put options for seventeen different currencies.
- Treasury also has a continuing program to actively hedge Microsoft's monthly exposure to foreign currency-denominated accounts receivable on a short-term rolling 30 day basis.

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MICROSOFT PREFERRED

- On December 17th, Microsoft issued its first security since the IPO in 1986. Microsoft issued 12.5m shares, or $1 billion, of "Convertible Exchangeable Principal-Protected Preferred Shares" with the the following properties:
  - The issue price was the closing price of Microsoft common stock on December 17th, or $79.875.
  - The Preferred issue will pay a quarterly dividend, based on an annual rate of 2.75%.
  - Dividends are cumulative and payable quarterly in arrears.
  - The issue provides investors 100% downside protection versus the initial offering price of $79.875.
  - Investors participate in Microsoft common stock appreciation up to 28% ($102.24); thereafter they are "capped" out.
  - Three years from the offering date, each outstanding Preferred Share will convert into Microsoft Common Shares, or an equivalent amount of cash at Microsoft's option.
  - The Preferred Shares are exchangeable at Microsoft's option for Convertible Subordinated Notes due 1999. At maturity, notes will be settled either in MS common stock or in cash.
- For the first time in the history of the company, Microsoft applied for a credit rating from Moody's Investor Service and Standard & Poors (S&P). The issue received a rating of "a1" from Moody's and "AA-" from S&P. S&P also assigned a "AA" rating to Microsoft Corp.
- The lead managers of the offering were Goldman, Sachs & Co. and Morgan Stanley & Co. Incorporated. Other participating brokers included:

First Tier	Second Tier
Alex Brown	Allen & Co.
Bankers Trust	Cowen & Co.
Bear Stearns & Co.	Dain Bosworth
Dean Witter	Edward D. Jones
Dillon Read	Furman Selz
Donaldson Lufkin & Jenrette	Piper Jaffrey
Deutsche Morgan Grenfell	Ragen MacKenzie
Montgomery Securities	Soundview Financial
Prudential Securities	
Paine Webber	
Robertson Stephens	
Smith Barney	
Salomon Brothers	

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INVESTOR RELATIONS

MSFT FINANCIAL ANALYST RATINGS

Firm	Analyst	Rating
Dean Witter	Peter Rubicam	Strong Buy
Donaldson, Lufkin & Jenrette	Frank Michnoff	Buy
DMG	Michael Kwatinetz	Buy
First Boston	Esther Schreiber	Buy
Furman Selz	Sanjiv Hingorani	Recommended
Goldman Sachs	Rick Sherlund	Recommended
Hambrecht & Quist	Christopher Gavin	Buy
Lehman Brothers	Michael Stanek	Outperform

Firm	Analyst	Rating
Paine Webber	Walter Winnitzski	Buy
Prudential	Lisa Thompson	Buy
Raymond James	N/A	N/A
Roberts, Stephens	Marshall Senk	Buy
Smith Barney	Jonathon Cohen	Favorable
Sound View	Russ Crabs	N/A
William Blair	Laura Lederman	Buy

N/A indicates analysts have recently switched firms and are in process of being replaced

- New coverage was initiated by Smith Barney (Jonathan Cohen), Lehman Brothers (Michael Stanek), and Paine Webber (Walter Winnitzski).
- All firms maintained the above ratings on MSFT throughout the quarter.

INSTITUTIONAL BUYERS AND SELLERS

Top 5 Buyers Q97-2 Institutions	Investment Style	Turnover Rate	Change Since September	September Position
J.P. Morgan Investment Management	Value	Mod	1,900,000	4,700,000
PNC Bank Corp.	Growth	Mod	1,600,000	1,600,000
Key Corp.	Value	Low	1,390,000	1,390,000
Merrill Lynch Asset Management	Value	Mod	1,200,000	1,700,000
Oppenheimer Funds	Gr. Income	Mod	944,800	1,964,800
Total			7,034,800	

Top 5 Sellers Q97-2 Institution	Investment Style	Turnover Rate	Change Since September	December Position
Putnam Investment Management, Inc.	Growth	Mod	(5,200,000)	1,000,000
Fidelity Management & Research	Growth	Mod	(2,500,000)	22,500,000
Columbus Circle Investors	Momentum	Mod	(1,900,000)	2,900,000
American Express Financial Advisors	Growth	Mod	(1,105,480)	4,794,520
Investors Research Corporation	Momentum	High	(980,000)	6,200,000
Total			(11,685,480)	

- Prior to Q97-2, Fidelity had been the largest purchaser of our common shares for two quarters in a row. However, this quarter saw Fidelity take some profits on its position as the stock price continued to appreciate during the quarter. Fidelity remains our largest non-index shareholder, with 22.5 million shares.
- Putnam Investment Management continued its liquidation of our common stock, selling 5.2 Million shares this quarter on top of the 1.8 Million shares it divested last quarter. The company feels that MSFT is over valued relative to other investment opportunities. Putnam has sold the vast majority of its holdings over the past two quarters.
- PNC Bank Corp was an aggressive purchaser of the stock this quarter after spending several quarters evaluating MSFT. PNC sees Windows NT as the primary driver for earnings for the foreseeable future.

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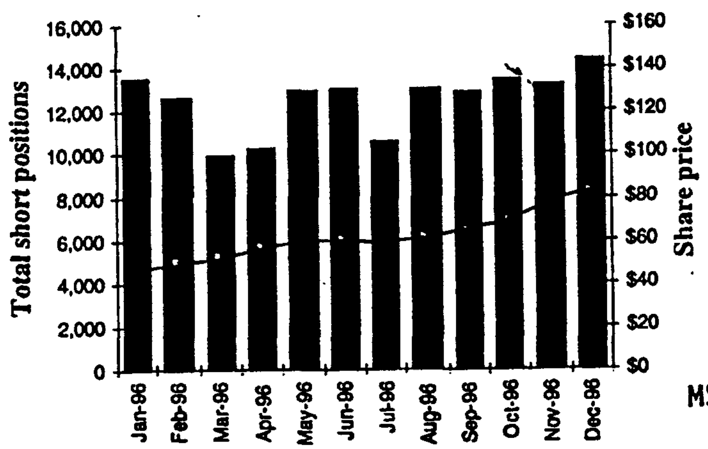
TOP INSTITUTIONAL HOLDERS

Top 15 Institution (Last Quarter's Rank)		Investment Style	Turnover Rate	Change Since June	September Position
1	BZW Barclays Global Advisors (1)	Index	Low	-280,000	30,720,000
2	Fidelity Management & Research (2)	Growth	Mod	-2,500,000	22,500,000
3	Bankers Trust Company (3)	Index	Low	-400,000	15,000,000
4	Alliance Capital Management L.P. (4)	Growth	Mod	450,000	13,650,000
5	State Street Global Advisors (5)	Index	Low	0	12,600,000
6	Provident Investment Counsel (6)	Growth	Mod	0	10,000,000
7	Janus Capital Corporation (7)	Momentum	High	0	7,400,000
8	College Retirement Equities Fund (9)	Index	Low	400,300	6,886,000
9	Vanguard Group (10)	Index	Low	0	6,500,000
10	Investors Research Corporation (8)	Momentum	High	-980,000	6,200,000
11	W.P. Stewart & Co. (14)	Growth	Mod	373,395	6,083,395
12	California Public Employees' Retirement System (11)	Index	Low	20,000	6,020,000
13	Mellon Bank (Private Asset Management) (12)	Index	Low	-300,000	5,700,000
14	State Street Research & Management Co. (16)	Growth	High	0	5,600,000
15	Jennison Associates Capital Corp. (15)	Growth	Mod	-200,000	5,400,000

- The theme of profit taking was reflected through the majority of our top 10 non-index shareholders. While still maintaining sizable positions, 9 out of MSFT's largest non-indexed shareholders either reduced their positions or kept them unchanged.

SHORT POSITIONS

- Short interest in MSFT continued to climb along with share price.
- Outstanding short positions represents 2.8 days of trading based on Decembers average daily volume. This is a slight increase over September 30th, and the highest volume of outstanding short shares in over a year.



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COMPETITOR HIGHLIGHTS

(Prices as of January 15, 1997)

ORACLE ($41 1/4)

- November quarter earnings of $0.27 per share were below analyst estimates of $0.28 per share due to disappointing European sales. Revenues increased 36% over the prior year to $1.31 billion. Oracle's stock price fell $3.25 per share, or 7%, the day following the announcement.
- Analysts see Oracle benefiting greatly from the paradigm shift to the Internet as all of their applications will be Internet-enabled by March 1997 and they have started focusing on products for electronic commerce over the Internet. While the Network Computer (NC) is not seen as a revenue generator, it has raised the visibility of the company and is helping them engage in discussions with higher-level executives. Oracle hopes to not only sell the server software for the NC, but the applications.
- Oracle System 8 is projected to ship by mid 1997. Also, management said that while Oracle applications based on Windows NT carry lower prices than high-end enterprise products, growth exceeds 100%.
- At its "Analyst Day and User Conference" in early November, Oracle management outlined a 4 part strategy targeted at achieving a much higher penetration of the corporate computing workplace. The strategy consists of:
  - transforming the company from a database provider to a strategic partner by focusing on vertical-based solutions rather than system-level products and selected applications,
  - moving from the UNIX developer market to the broader computing market,
  - migrating from client/server computing to network computing, and
  - building an internal organization with more consistent processes and greater productivity.

SUN MICROSYSTEMS ($28 1/4)

- December quarter earnings of $0.46 per share exceeded consensus estimates of $0.42 by 10%. Net income grew 41% over the prior year to $178 million on sales growth of 19%.
- Analysts believe Java's success is improving Sun's ability to sell servers and workstations into the corporate market. They expect the software business to exceed 10% of sales and 20% of gross profit in fiscal 1998, compared to today's levels of 4% and 6%, respectively.
- Sun announced that 100 companies joined in support of its Pure Java standardization initiative, an attempt to keep Java from being fragmented with different versions. Others in support included IBM, Netscape, Apple, and Oracle.
- Sun has been significantly increasing its sales force in an effort to have more "feet on the street." Analysts believe Sun has been gaining market share and mindshare with its strong product line and its public relations are the best they have been in recent history. The question analysts ask is whether the additional sales force will convert opportunity into orders.
- Analysts believe one reason Sun's stock price has shown softness of late is due to the threat of Windows NT. Hewlett-Packard has criticized Sun for its UNIX-only approach being out of sync with customer needs and analysts expect Sun to explain how it will help customers tie together UNIX and NT at its February analyst meeting.
- Analysts expect server and workstation price reductions, combined with a slowdown in the order growth rate to lead to slower revenue growth and declining margins. However, greater operating expense control for fiscal 1997 and 1998 should still allow Sun to meet earnings expectations.
- Sun's JavaSoft division is expected to exit FY 97 with approximately 500 employees and will post only a modest loss. Analysts believe JavaSoft's FY 97 revenues will be in the range of $50 to $65 million.

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IBM ($164 5/8)

- Analysts are extremely positive on the "new" IBM as they react much more quickly to their troubles. have opportunities to gain market share in certain businesses. and still have room to cut costs. Additionally. certain analysts believe there is still room for price multiple expansion and EPS growth beyond what is currently expected by the Street.
- Analysts believe IBM's PC division is gaining market share and improving gross margins. PC inventory levels are the lowest in company history and channel inventories have been cut in half from the first quarter of 1996. Helping the gross margin, IBM expects over half of all commercial desktops to be assembled in the local sales region in the first quarter of 1997.
- Lotus released the Domino 4.5 server and the Notes 4.5 client, which allows, among other features. the creation of groupware applications for the Internet and corporate intranets that are accessible via Web browsers or Notes 4.5 clients.
- Acquired Edmark at a price of $15.50 per share, or approximately $80 million. At the date of the offer, Edmark common stock was trading at $11 3/8; its 52-week high was $41.
- Netscape will integrate IBM's Host On-Demand, a Java-based web-to-host software, into Netscape Communicator Professional Edition. In return, IBM is licensed to include Netscape Communicator Professional Edition with various IBM hardware and software offerings.
- IBM's board authorized a $3.5 billion repurchase program which is expected to carry them through the third quarter of 1997. Since January 1995, IBM has repurchased $9.7 billion of its common stock.

NOVELL ($9 15/16)

- October quarter earnings were in line with analyst estimates of $0.17 per share which compared to $0.16 per share in the prior year. Revenues decreased 20% from the prior year to $384 million due to the divestitures of WordPerfect and Unix.
- Announced free availability of a single server version of Novell Directory Services (NDS). Novell wants NDS to become the directory of choice for the Internet and hopes to generate revenues through subsequent licenses of NDS and new applications surrounding NDS, such as server replication, messaging network management, and security.
- In early November the Wall Street Journal rumored IBM, Seagate Technology, and Sun were interested in buying Novell. Novell's stock closed up 26% to $11 ½ on 13.4 million shares traded compared to their average daily volume of 2 million shares. Novell's price has since fallen back to $10 and analysts generally don't believe Novell is an attractive acquisition candidate. Management has also stated that they believe Novell remaining independent will obtain the greatest shareholder value.
- Consistent with the sense of urgency management says it has instilled at Novell, the company announced that it will be releasing Internet products three to four times a year. IntranetWare, the Intranet successor to NetWare 4.11, was released in October with a new version anticipated in January.
- Novell agreed to license Sun's Java technology and provide it to Novell application developers and customers in exchange for Sun licensing Novell Directory Services (NDS) and making it available to Sun's Solaris customers.
- John A. Young, Novell chairman, indicated CEO candidates are being identified and reviewed with finalization expected in the next three or four months.
- Alan C. Ashton, a founder of WordPerfect, resigned from the Board to pursue community and other interests in Utah.

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NETSCAPE ($42 1/4)

- On January 8th, three analysts coincidentally noted that because of "lengthening sales cycles" and "product transitions". Netscape would not likely exceed analyst estimates for the December quarter. Subsequently, the stock price has dropped 28%. As a result of the price decline, several analysts have upgraded their ratings.
- Based on a Netcraft survey released January 9th, Netscape's Internet Web server market share started and ended 1996 at 13.7% after reaching a high of 16.2% in May. Microsoft's market share increased from 0% to 10.6% by the end of the year.
- Analysts see Netscape's shift in focus to emailing and groupware as a new market for them, which is led by Lotus and Microsoft. Netscape's competing product, Communicator, will include Navigator, Composer (HTML authoring), Messenger (email), Collabra (group discussion), and Conference (real-time collaboration).
- Constellation, software for netcasting, roaming, and desktop customization was previewed at Comdex and will be bundled in future versions of Communicator. Netscape will use Marimba's Castanet Tuner technology and Pointcast to "push" the information to the desktop rather than the end-user having to seek out the information. Analysts don't believe Constellation will provide any near term revenue but certain analysts believe it could compete with Windows as the standard front end over the longer term.
- SuiteSpot 3.0, integrated server products for building Intranets, and Communicator 4.0 are expected to release in the March quarter. SuiteSpot will include "Inbox Direct" which will allow content providers (Reuters, Dow Jones, etc.) to automatically send information to enterprise users of Communicator.
- Netscape sold 5.6 million shares of its common stock at $53.75 per share in a mid-November secondary offering. Four early investors - Knight-Ridder, Adobe, TCI and Hearst Corp. - sold three million of the shares with the remaining shares being sold by Netscape.
- Hewlett-Packard will become the first worldwide support provider for Netscape's entire line of Internet and intranet software. The companies announced previously their agreement to jointly deliver enterprise intranet solutions to customers.

COREL ($7 15/16)

- November quarter earnings equaled analyst expectations of $0.09 per share compared to the prior year loss of $0.02 per share. The fiscal 1996 loss of $2.8 million, or $0.04 per share, compares to net income of $14.4 million, or $0.26 per share, for fiscal 1995. Corel's cash balance was $6.9 million at fiscal year end.
- Incredibly, Corel's earnings release highlighted a 102% increase in revenues while not disclosing the lack of WordPerfect revenues in the prior year, destroying any comparability.
- Two days before the launch of Office 97, Corel announced it would integrate Netscape's Communicator (email, conferencing, and other collaboration software) into Corel WordPerfect Suite 8 and Corel Office Professional 8.
- A new low-priced program for Corel Office for Windows NT Server 4.0 will offer simultaneous, unlimited usage of all applications in the suite to all users connected to the server. Pricing will be available in three different manners: a shrink-wrap single license for $1,995; Corel License Program (CLP) Choice which allows all licenses after the first to be purchased for $1,595; and larger organizations can utilize CLP Universal for an incremental cost of $1,200 for all licenses purchased over 25.
- In addition to Oracle, Sun, and IBM, Corel expects to release its Network Computer by March 1997. Corel's NC will use Motorola's MPC 821 Power PC processor chip and will ship with Corel Office for Java.
- Analysts remain concerned about Corel's dwindling cash flow, lack of management team depth, and maturation of CorelDraw's market. Corel's stock price is below $8, after trading as high as $15 this year.

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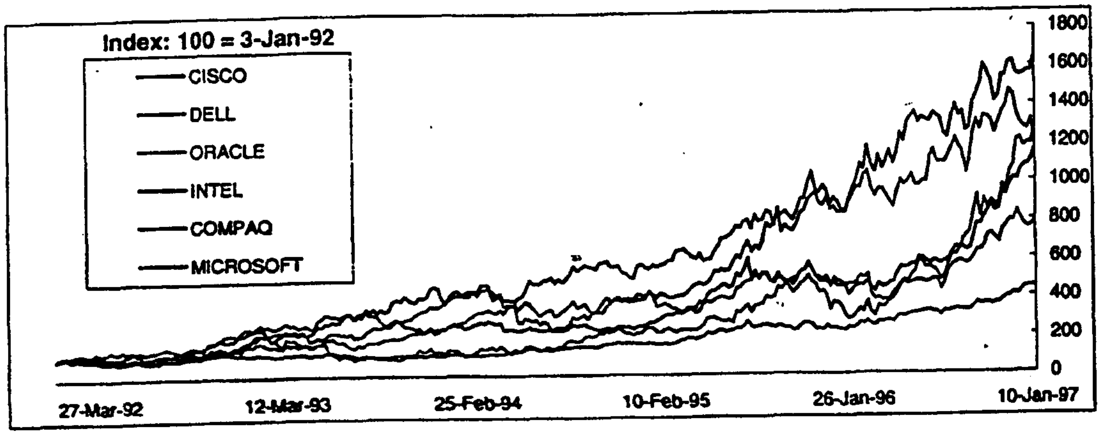
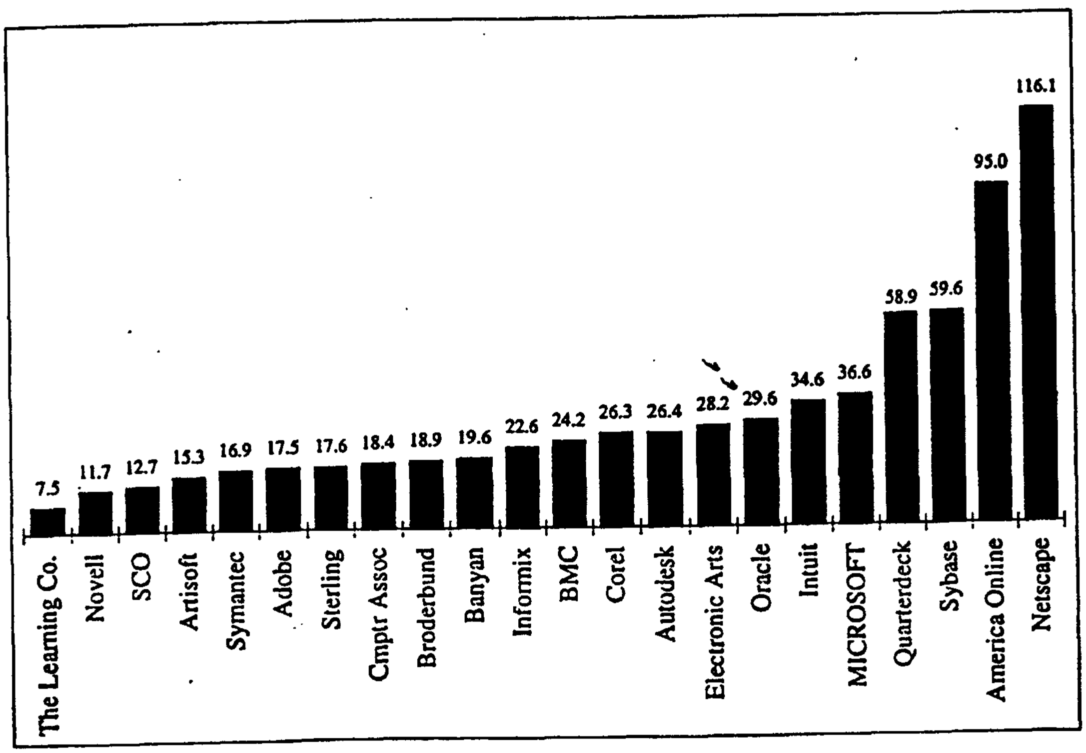
KEY COMPETITOR STOCK PRICES



SOFTWARE FORWARD P/E RATIOS



a) Forward P/E ratios are calculated based upon December 31, 1996 stock prices and analyst's consensus estimates for the next four quarters.

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AUTHOR: TIM HALLADAY (TIMHALL)

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INDUSTRY REVIEW

SOFTWARE COMPANIES

(in millions)

Income statement	Adobe 11/29/96	America Online 9/30/96	Artisoft 9/30/96	Autodesk 10/31/96	BMC 9/30/96	Banyan 9/30/96
Most recent quarter						
Net revenue	$208 (a)	$350	$11	$117	$127	$28
Net income (loss)	68	(354) (d)	(3)	6	35	(1)
EPS	0.92	(3.80)	(0.23) (e)	0.13	0.66	(0.05)
Trailing twelve months						
Net revenue	$787	$1,246	$57	$508	$500	$116
Net income (loss)	153	(312)	(22) (f)	52	114 (h)	(18) (i)
EPS	2.04 (b)	(2.95)	(1.53)	1.09	2.16	(1.03)
Net income (loss) as a % of net revenues	19%	(25%)	(39%)	10%	23%	(15%)
Balance sheet						
Cash	$564	$102	$16	$161	$118	$20
Other current assets	173	153	26	138	90	36
Other assets	275	284	14	178	492	36
	$1,012	$539	$56	$477	$700	$92
Liabilities	$234	$360	$8	$168	$246	$46
Equity	707	179	48	244 (g)	454	46
	$1,012	$539	$56	$477	$700	$92
Other data						
Closing stock price (Dec. 31, 1996)	$37.38	$33.25	$5.19	$28.00	$41.38	$4.50
Common shares outstanding (in millions)	74	93	15	45	53	17
Market value (in millions)	$2,766	$3,092	$78	$1,260	$2,193	$77
Price/revenue ratio	3.5x	2.5x	1.4x	2.5x	4.4x	0.7x
Price/earnings ratio - trailing twelve	18.3x	n/m	n/m	25.6x	19.1x	n/m
Price/earnings ratio - future 4 qtrs.	17.5x	95.0x	15.3x	26.4x	24.2x	19.6x
Headcount (most recent disclosure)	2,319	5,828	363	1,894	1,444	762
Net revenue/employee (in thousands)	$339	$214	$157	$268	$346	$153
Book value per share	$9.55	$1.92	$3.20	$5.42	$8.57	$2.71
Price/book value ratio	3.9x	17.3x	1.6x	5.2x	4.8x	1.7x
Growth statistics (over comparable quarter):						
Revenue	3%	77%	(26%)	(9%)	43%	(10%)
Research and development	1%	102%	91%	21%	50%	(14%)
Sales and marketing	(3%)	105%	9%	9%	61%	(30%)
General and administrative	(14%)	74%	6%	0%	40%	(22%)

a) Adobe's current quarter included a $59.4 million gain on the sale of venture investments, including Netscape, and an $11.5 million charge for the write-off of R&D and restructuring charges.
b) Adobe's trailing 12 months included $14.7 million for the write-off of purchased R&D.
c) Adobe's comparable quarter included a $31.5 million restructuring charge and a $15 million R&D write-off.
d) AOL's current quarter included a $385 charge to write-off capitalized marketing expenses.
e) Artisoft's current quarter included charges of $0.08 per share for restructuring charges.
f) Artisoft's trailing twelve months included charges of $26.8 million relating to acquisitions including Stylus Innovation.
g) Autodesk entered into a merger agreement with Softdesk Inc. valued at $72 million.
h) BMC's trailing 12 months included acquisition charges of $34 million.
i) Banyan's trailing 12 months included after tax charges of $11 million.

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SOFTWARE COMPANIES - CONTINUED

(in millions)

	Borland	Broderbund	CompuServe	Computer Assoc.	Corel	Electronic Arts
Income statement	9/30/96	11/30/96	10/31/96	9/30/96	11/30/96	9/30/96
Most recent quarter						
Net revenue	$36 (a)	$61	$214	$990	$125	$129
Net income (loss)	(10)	9	(58) (d)	223	7	6
EPS	(0.31)	0.42	(0.63)	0.59	0.09	0.11
Trailing twelve months						
Net revenue	$181	$177	$841	$3,897	$334	$567
Net income (loss)	(15)	30 (c)	(79) (e)	835	(3)	43
EPS	(0.47)	1.40	(0.94)	2.20	(0.04)	0.78
Net income (loss) as a % of net revenues	(8%)	17%	(9%)	21%	(1%)	8%
Balance sheet						
Cash	$84	$149	$185	$203 (f)	$7	$152
Other current assets	26	56	211	1,045	188	155
Other assets	117	22	4,480	3,628	203	135
	$227	$227	$4,876	$4,876	$398	$442
Liabilities	$78	$52	$4,192	$3,283	$108	$105
Equity	149 (b)	175	684	1,593	290	337
	$227	$227	$4,876	$4,876	$398	$442
Other data						
Closing stock price (Dec. 31, 1996)	$5.44	$29.75	$9.88	$49.75	$7.38	$29.94
Common shares outstanding (in millions)	31	21	33	380	71	55
Market value (in millions)	$169	$625	$326	$18,905	$524	$1,647
Price/revenue ratio	0.9x	3.5x	0.4x	4.9x	1.6x	2.9x
Price/earnings ratio - trailing twelve	n/m	21.2x	n/m	22.6x	n/m	38.5x
Price/earnings ratio - future 4 qtrs.	n/m	18.9x	n/m	18.4x	26.3x	28.2x
Headcount (most recent disclosure)	706	638	3,650	8,800	594	1,500
Net revenue/employee (in thousands)	$256	$277	$230	$443	$563	$378
Book value per share	$4.81	$8.33	$20.73	$4.19	$4.09	$6.13
Price/book value ratio	1.1x	3.6x	0.5x	11.9x	1.8x	4.9x
Growth statistics (over comparable quarter):						
Revenue	(29%) (a)	(13%)	186%	22%	102% (h)	37%
Research and development	16%	17%	(33%)	13%	119%	36%
Sales and marketing	(4%)	31%	112%	23%	61%	30%
General and administrative	n/a	3%	70%	5%	61%	58%
Net income	(471%) (a)	(44%)	(516%) (d)	135% (g)	785%	97%

a) Borland's current quarter reflected slower than expected client/server and Internet/intranet software sales.
b) Borland announced it will report a loss of $0.52 to $0.62 per share in the December quarter due to slowing sales, one-time charges on its Open Environment acquisition, and worldwide restructuring charges.
c) Broderbund's trailing 12 months included a $16 million break-up fee from the terminated merger with The Learning Company and an $8 million write-off for in-process technology related to its T/Maker acquisition.
d) CompuServe's current quarter included a $45 million charge for a change in its deferred subscriber acquisition costs amortization period and an $8 million charge for the termination of its WOW! online service.
e) CompuServe's trailing 12 months included an $18 million charge for the disposition of Spry.
f) Computer Associates announced it would purchase Cheyenne Software for $1.2 billion in cash.
g) Computer Associates' comparable quarter included purchased R&D charges of $808 million for the Legent acquisition.
h) Corel's current quarter included WordPerfect. Prior quarters will not be restated since the acquisition was a purchase, not a pooling.

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SOFTWARE COMPANIES - CONTINUED

(in millions)

	Informix 9/29/96	Intuit 10/31/96	The Learning Company 9/30/96	Microsoft 12/31/96	Netscape 9/30/96	Novell 10/26/96
Income statement						
Most recent quarter						
Net revenue	$238	$103	$90	$2,680	$100	$384
Net income (loss)	26	(28) (a)	(93) (b)	741	8	59
EPS	0.17	(0.61)	(2.08)	0.57	0.09	0.17
Trailing twelve months						
Net revenue	$886	$552	$285	$9,436	$271	$1,375
Net income (loss)	103	(29)	(402) (c)	2,475	16 (d)	126 (e)
EPS	0.68	* (0.62)	(11.13)	1.92	0.18	0.35
Net income (loss) as a % of net revenues	12%	(5%)	(141%)	26%	6%	9%
Balance sheet						
Cash	$250	$171	$104	$9,160	$98	$1,025
Other current assets	289	132	97	1,282	105	566
Other assets	291	136	693	2,344	129	458
	$830	$439	$894	$12,786	$332	$2,049
Liabilities	$316	$155	$701	$3,144	$133	$433
Equity	514	284	193	9,642	199	1,616
	$830	$439	$894	$12,786	$332	$2,049
Other data						
Closing stock price (Dec. 31, 1996)	$20.38	$31.50	$14.38	$82.63	$56.88	$9.47
Common shares outstanding (in millions)	156	46	45	1,304	88	346
Market value (in millions)	$3,179	$1,449	$647	$107,750	$5,005	$3,276
Price/revenue ratio	3.6x	2.6x	2.3x	11.4x	18.5x	2.4x
Price/earnings ratio - trailing twelve	30.2x	n/m	n/m	43.1x	314.5x	26.9x
Price/earnings ratio - future 4 qtrs.	22.6x	34.6x	7.5x	36.6x	116.1x	11.7x
Headcount (most recent disclosure)	3,219	3,474	775	20,992	1,150	5,737
Net revenue/employee (in thousands)	$275	$159	$368	$450	$235	$240
Book value per share	$3.29	$6.17	$4.29	$7.39	$2.26	$4.67
Price/book value ratio	6.2x	5.1x	3.4x	11.2x	25.2x	2.0x
Growth statistics (over comparable quarter):						
Revenue	30%	0%	117%	22%	329%	(20%) (f)
Research and development	41%	11%	214%	55%	240%	(30%)
Sales and marketing	32%	6%	81%	7%	272%	1%
General and administrative	36%	18%	19%	6%	223%	(11%)
Net income	10%	(39%) (a)	(1,028%) (b)	29%	4,275%	0%

a) Intuit's current quarter included a $4.9 million charge for purchased R&D in the acquisition of GALT Technologies.
b) The Learning Company's (formerly SoftKey) current quarter included a $120 million charge relating to the acquisitions of The Learning Company, Minnesota Educational Computing Corporation (MECC), and Compton's New Media.
c) The Learning Company's trailing 12 months included charges of $473 million related to acquisitions of The Learning Company, MECC and Compton's New Media.
d) Netscape's trailing 12 months included charges of $6.1 million, or $0.06 per share, for acquisitions.
e) Novell's trailing twelve months included a $0.04 per share gain on the sale of WordPerfect to Corel.
f) Novell's comparable quarter included $55 million of revenue from sold and discontinued business lines.

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SOFTWARE COMPANIES - CONTINUED

(in millions)

	Oracle 11/30/96	Quarterdeck 9/30/96	Santa Cruz Operation 9/30/96	Sterling 9/30/96	Sybase 9/30/96	Symantec 9/30/96
Income statement						
Most recent quarter						
Net revenue	$1,311	$20	$55	$126	$250	$109
Net income (loss)	179	(55) (a)	4	35	(53) (f)	1 (g)
EPS	0.27	(1.53)	0.11	0.93	(0.69)	0.02
Trailing twelve months						
Net revenue	$4,848	$134	$208	$613	$1,011	$445
Net income (loss)	705	(74) (b)	(22) (c)	238 (e)	(78)	12
EPS	1.06	(2.27)	(0.61)	6.79	(1.04)	0.22
Net income (loss) as a % of net revenues	15%	(59%)	(11%)	39%	(8%)	3%
Balance sheet						
Cash	$879	$36	$55	$756	$156	$140
Other current assets	1,448	17	47	159	380	94
Other assets	1,134	34	65	183	306	64
	$3,461	$77	$167	$1,098	$722	$298
Liabilities	$1,325	$73	$65	$219	$330	$109
Equity	2,136	4	102	879	392	189
	$3,461	$77	$167	$1,098	$722	$298
Other data						
Closing stock price (Dec. 31, 1996)	$41.75	$4.13	$7.00	$31.63	$16.69	$14.50
Common shares outstanding (in millions)	676	36	38	38	76	55
Market value (in millions)	$28,223	$149	$266	$1,202	$1,268	$798
Price/revenue ratio	5.8x	1.2x	1.3x	2.0x	1.3x	1.8x
Price/earnings ratio - trailing twelve	39.4x	n/m	n/m	4.7x	n/m	65.3x
Price/earnings ratio - future 4 qtrs.	29.6x	58.9x	12.7x	17.6x	59.6x	16.9x
Headcount (most recent disclosure)	25,000	600	1,188	2,600	2,528	1,442
Net revenue/employee (in thousands)	$194	$207	$175	$236	$400	$309
Book value per share	$3.16	$0.11	$2.68	$23.13	$5.16	$3.44
Price/book value ratio	13.2x	37.2x	2.6x	1.4x	3.2x	4.2x
Growth statistics (over comparable quarter):						
Revenue	36%	(37%) (a)	17%	9%	7%	1%
Research and development	45%	43%	38%	(23%)	2%	(12%)
Sales and marketing	27%	49%	(1%)	13%	4%	(12%)
General and administrative	22%	79%	16%	n/a	0%	(34%)
Net income	31%	(19818%) (a)	258% (d)	23%	(4708%) (f)	105%

a) Quarterdeck's current quarter reflected an $8 million higher than normal returns reserve, $15 million for in-process R&D charge-offs, and $13 million in restructuring charges.
b) Quarterdeck's trailing 12 month results included non-recurring charges of $41 million for acquisitions, restructuring, and returns reserves.
c) SCO's trailing 12 months included a $38 million charge for the acquisition of the UNIX business from Novell.
d) SCO's comparable quarter included restructuring charges of $4 million.
e) Sterling's trailing 12 months included a $126 million gain, net of tax, from an initial public offering of a subsidiary.
f) Sybase's current quarter included a $49 million charge for elimination of non-core products and restructuring charges.
g) Symantec's current quarter included $8 million in acquisition and other non-recurring charges.

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HARDWARE COMPANIES

(in millions)

	AST	Apple	Cisco	Compaq	DEC	Dell
Income statement	9/28/96	12/27/96	10/26/96	9/30/96	9/28/96	10/27/96
Most recent quarter						
Net revenue	$408	$2,129	$1,435	$4,481	$2,912 (g)	$2,019
Net income (loss)	(135) (a)	(120) (c)	181	350	(75)	145
EPS	(2.41)	(0.96)	0.26 (e)	1.25	(0.48)	1.52
Trailing twelve months						
Net revenue	$2,105	$8,814	$4,733	$17,388	$14,203	$6,886
Net income (loss)	(478) (b)	(867) (d)	913	933 (f)	(261) (h)	400
EPS	(10.06)	(6.98)	1.35	3.37	(1.69)	4.10
Net income (loss) as a % of net revenues	(23%)	(10%)	19%	5%	(2%)	6%
Balance sheet						
Cash	$30	$1,807	$1,277	$3,191	$2,041	$1,183
Other current assets	585	2,612	1,238	4,805	4,984	1,308
Other assets	171	853	1,787	1,348	2,613	233
	$786	$5,272	$4,302	$9,344	$9,638	$2,724
Liabilities	$735	$3,330	$1,217	$3,807	$6,151	$1,702
Equity	51	1,942	3,085	5,537	3,487	851
	$786	$5,272	$4,302	$9,344	$9,638	$2,724
Other data						
Closing stock price (Dec. 31, 1996)	$4.19	$20.88	$63.63	$74.38	$36.25	$53.13
Common shares outstanding (in millions)	56	125	683	279	154	96
Market value (in millions)	$235	$2,609	$43,456	$20,751	$5,583	$5,100
Price/revenue ratio	0.1x	0.3x	9.2x	1.2x	0.4x	0.7x
Price/earnings ratio - trailing twelve	n/m	n/m	47.0x	22.1x	n/m	12.9x
Price/earnings ratio - future 4 qtrs.	n/m	n/m	28.5x	13.6x	21.2x	16.5x
Headcount (most recent disclosure)	5,700	10,896	8,782	17,055	57,000	9,700
Net revenue/employee (in thousands)	$369	$809	$539	$1,020	$249	$710
Book value per share	$0.91	$15.54	$4.52	$19.85	$22.64	$8.86
Price/book value ratio	4.6x	1.3x	14.1x	3.7x	1.6x	6.0x
Growth statistics (over comparable quarter):						
Revenue	1%	(32%)	80%	25%	(11%) (g)	43%
Research and development	(7%)	(3%)	85%	62%	0%	27%
Sales and marketing	52%	(16%)	78%	16%	0%	34%
General and administrative	n/a	n/a	48%	n/a	n/a	n/a
Net income	(40%) (a)	(74%)	0% (e)	43%	(290%) (g)	93%

a) AST's current quarter included a $22 million charge for the write-off of goodwill on its 1993 acquisition of Tandy's personal computer manufacturing operations. AST will receive bank credit guarantees of $100 million in December 1996 and again in April 1997 from Samsung in exchange for shares of AST non-voting preferred stock. These guarantees are in addition to the $200 million previously provided by Samsung.

b) AST's trailing 12 months included $35 million in charges for restructuring and goodwill write-offs.

c) Apple's current quarter suffered from shortfalls in planned sales of its consumer-oriented Performa in the United States.

d) Apple's trailing 12 months reflected an after-tax inventory writedown of $388 million, restructuring charges of $112 million after-tax, and a $39 million after-tax gain on the sale of their investment in America Online.

e) Cisco's current quarer included a $0.26 per share charge for in process R&D and a $0.05 gain on the sale of a minority stock investment.

f) Compaq's trailing 12 months included a $241 million, or $0.87 per share, charge for purchased in-process technology in connection with the acquisitions of NetWorth and Thomas-Conrad Corp.

g) DEC's current quarter revenues declined due to implementation of a new sales model and lower service revenues.

h) DEC's trailing twelve months included a $492 million restructuring charge.

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HARDWARE COMPANIES - CONTINUED

(in millions)

	Gateway 9/30/96	Hewlett Packard 10/31/96	IBM 9/30/96	Intel 12/28/96	Silicon Graphics 9/30/96	Sun 12/29/96
Income statement						
Most recent quarter						
Net revenue	$1,203	$10,147	$18,062	$6,440	$766	$2,082
Net income (loss)	61	648	1,280	1,910	(22) (e)	178
EPS	0.78	0.62	2.45	2.13	(0.13)	0.46
Trailing twelve months						
Net revenue	$4,728	$38,420	$74,724	$20,847	$3,092	$7,799
Net income (loss)	221	2,586	5,097 (b)	5,157	35 (f)	567
EPS	2.83	2.46 (a)	9.47	5.81	0.20	5.40
Net income (loss) as a % of net revenues	5%	7%	7%	25%	1%	7%
Balance sheet						
Cash	$401	$3,327	$7,002	$7,994	$292	$751
Other current assets	681	14,664	32,377	5,690	1,645	2,218
Other assets	334	9,708	38,617	10,051	1,023	898
	$1,417	$27,699	$77,996	$23,735	$2,960	$3,867
Liabilities	$1,416	$14,261	$56,628	$6,588	$1,291	$1,563
Put warrants	0	0	0	275	0	0
Equity	725	13,438	21,368	16,872 (d)	1,669	2,304
	$1,417	$27,699	$77,996	$23,735	$2,960	$3,867
Other data						
Closing stock price (Dec. 31, 1996)	$53.56	$50.25	$151.50	$130.53	$25.50	$25.69
Common shares outstanding (in millions)	78	1,047	522	897	173	389
Market value (in millions)	$4,185	$52,612	$79,083	$117,087	$4,412	$9,992
Price/revenue ratio	0.9x	1.4x	1.1x	5.6x	1.4x	1.3x
Price/earnings ratio - trailing twelve	18.9x	20.4x	16.0x	22.5x	125.5x	4.8x
Price/earnings ratio - future 4 qtrs.	14.6x	17.0x	12.5x	17.0x	23.4x	14.7x
Headcount (most recent disclosure)	9,000	112,000	252,000	48,500	10,358	17,407
Net revenue/employee (in thousands)	$525	$343	$297	$430	$298	$448
Book value per share	$9.28	$12.83	$40.93	$18.81	$9.65	$5.92
Price/book value ratio	5.8x	3.9x	3.7x	6.9x	2.6x	4.3x
Growth statistics (over comparable quarter):						
Revenue	35%	12%	8%	41%	29%	19%
Research and development	n/a	13%	8%	48%	49%	20%
Sales and marketing	69%	10%	8%	27%	35%	40%
General and administrative	n/a	n/a	n/a	n/a	n/a	n/a
Net income	48%	(4%)	336% (c)	120%	(137%) (e)	41%

a) HP's trailing 12 months included a $0.13 per share charge for the exit from disk-mechanism manufacturing.
b) IBM's trailing 12 months included non-recurring charges of $488 million.
c) IBM's comparable quarter includes a $1.8 billion charge for the write off of purchased technology in the Lotus acquisition. Earnings per share would have been $3.26 higher without the charge.
d) Intel's Board of Directors approved a two-for-one stock split, subject to shareholder approval.
e) Silicon's current quarter included $10 million in charges for retrofitting of microprocessor boards and $21 million in Cray Research merger related expenses.
f) Silicon's trailing 12 months included a $102 million charge for in-process R&D relating to the Cray Research acquisition.

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Appendix

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INVESTMENTS

WANG LABORATORIES, INC.

(Financial information shown below is the most recent available.)

	Sept. 30, 1995	Sept. 30, 1996	Change $	Change %
Net revenue	$264	$291	$27	10%
Operating expenses	247	276	29	12%
Operating income (loss)	17	15	(2)	NM
Other income (expenses)	(47)	(39)	8	NM
Net income	($30)	($24)	$6	NM

- Wang continues to expand as a service provider and a developer of open systems software for NT. A decreasing percentage of revenues now come from support for its now terminated proprietary hardware products.
- For the quarter, service revenue increased 14.6% to $207.8 million. Proprietary product revenues declined again. Open system software sales increased 18.1% to $10.2 million. Due to high investment levels, the software business had negative EBITDA of $8.5 million.
- During the quarter, the Boston Globe reported that Kodak was in discussions to purchase Wang's software businesses for about $300 million. Such a transaction should increase the value of Microsoft's convertible preferred investment in Wang.
- Microsoft's technical / marketing and patent agreements with Wang can not be assigned without Microsoft's consent.
- For the fiscal year ended June 30, 1996, net revenue increased 15% with service revenue increasing 24% and product (including software) revenue growing 1%.

MOBILE TELECOMMUNICATIONS TECHNOLOGIES CORPORATION (MTEL)

(Financial information shown below is the most recent available.)

	Sept. 30, 1995	Sept. 30, 1996	Change $	Change %
Net revenue	$64	$92	$28	44 %
Operating expenses	61	80	19	31
EBITDA	3	12	9	NM
Other expenses	(10)	(41)	(31)	NM
Net income	($7)	($29)	($22)	NM

- Mtel is the leading provider of nationwide and alpha-numeric paging services under the SkyTel brand. Mtel is also developing SkyTel 2-Way, which has caused a dramatic increase in operating expenses.
- Mtel recorded a 38% year-over-year increase in net pager units in service to 1.3 million units. However, net units increased by only 39 thousand in the 3rd quarter due in part to a strategy of reducing units sold through lower margin and higher churn distribution channels.
- Skytel's quarterly operating cash flow (OCF) was $29.6 million, a 142.6% increase over the comparable quarter. Overall, Mtel's OCF remained negative due to the investment in its 2-way network and international operations.
- Mtel aims to re-launch its two-way paging system in April 1997.

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STAC, INC.

(Financial information shown below is the most recent available.)

(In millions)	Twelve Months Ended Sep. 30, 1995	Twelve Months Ended Sep. 30, 1996	Change $	Change %
Net revenue	$45.8	$46.8	$1.0	2 %
Cost of revenue	5.4	6.5	1.1	20
Gross profit	40.4	40.3	(0.1)	(0)
Controllable expenses	40.5	42.1	1.6	4
Net income	($0.1)	($1.8)	($1.7)	NM

- June 1994, MS and Stac signed cross-license and investment agreements to end a disk compression patent dispute. MS agreed to pay Stac license royalties of $1 million per month for 43 months. MS also purchased $40 million of 4.0% convertible preferred stock, which was converted to common equity on November 9, 1995.
- Revenues were flat versus the year-ago period. Software sales declined 17% while hardware revenues increased 85%.
- Controllable expenses in the current nine month period include $12.2 million of purchased R&D. Before this charge, net income would have been $10.5 million.
- At a price of $7-7/8, MS's 4,458,746 shares of Stac common stock have a market value of $35 million.

SANTA CRUZ OPERATION, INC.

(Financial information shown below is the most recent available.)

(In millions)	FY95 Ended Sept. 30, '95	FY96 Ended Sept. 30, '96	Change $	Change %
Net revenue	$199	$208	$9	5 %
Cost of revenue	53	52	(1)	(2)
Gross profit	146	156	10	7
Controllable expenses	152	178	26	17
Net income	($6)	($22)	($16)	267

- SCO sent Microsoft a letter in which they want "out" of the 1987 "Centaur" Agreement (originally entered into between MS and AT&T). The Centaur agreement requires SCO to make its UNIX/Intel operating systems "binary(backward) compatible" and requires SCO to pay MS a royalty of $15 per copy. SCO claims that there is no longer any legitimate business reason to maintain binary compatibility and therefore, to continue to pay royalties to MS, and that any MS insistence on keeping the Agreement in force is anticompetitive/antitrust violation. The companies are currently discussing and Scott MacGregor, SCO Senior VP for Products was in Redmond in January 14, 1997.
- SCO management is under a lot of pressure to fight an unusual high turnover, and is developing special retention programs to lower the turnover rate.
- SCO bought back $3 million of its shares in Q3 CY96.
- SCO made a $2 million convertible loan to JBS (Jones Business Systems - a reseller) for the marketing of SCO products.
- Without "non-recurring charges", SCO's net income would have been $10.0 million and $12.9 million respectively for FY95 and FY96. The

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charges in FY96 were due to the acquisition of the Unixware system from Novell.

WorldCom, Inc

(Financial information shown below is the most recent available.)

(In millions)	Quarter Ended Sept. 30, 1995	Quarter Ended Sept. 30, 1996	Change $	Change %
Net revenue	$ 939	$ 1,132	$ 193	21 %
Cost of revenue (line costs)	512	608	96	19
Gross profit	939	1,132	193	21
Controllable expenses	886	1,023	137	15
Net income	$ 53	$ 109	$ 56	106

- On January 2, WorldCom completed its merger with MFS and each MFS share was converted to 2.1 WorldCom shares. Microsoft holds 15.5 million shares, 2.2% of WorldCom, worth $415 million as of January 10th. MS's ownership derives from its investment in UUNET, which was acquired by MFS on August 12, 1996.
- Third quarter revenue growth included a 30% increase in private line and frame relay revenues and a 22% increase in switched retail and wholesale business revenues.
- Microsoft's Network Agreement with UUNET, which is expected to continue in the foreseeable future, is still being renegotiated to provide for more favorable terms.

MicroUnity Systems Engineering, Inc.

(Financial statements not meaningful)

- Facing severe financial problems, MicroUnity was planning for an IPO in September, but none of the investment banks they met with agreed to help them. They stated that MU was in too many businesses, it was confusing, that they were still a "concept" IPO and that they had too large a cash burn rate.
- MU finally closed its fab on July 2, sold it to Interconnect for $11 million in cash and the assumption of the $17 million lease.
- MU laid off all but 30 people, and will continue to function as a "core technology" company.

Individual, Inc.

(Financial information shown below is the most recent available)

(In millions)	Quarter Ended Sept. 30, 1995	Quarter Ended Sept. 30, 1996	Change $	Change %
Net revenue	$4.4	$6.1	$1.7	39 %
Cost of revenue	2.1	3.0	0.9	43
Gross profit	2.3	3.1	0.8	35
Controllable expenses	4.0	7.4	3.4	85
Net income	($1.7)	($4.3)	($2.6)	153

- Although revenue continues to advance steadily (9% over Q97-1), expenses are up 28% and the Company's burn rate is accelerating. Individual has $34mm of cash and investments with which to fund its operations.
- On October 17th Individual completed its $2mm acquisition of the assets of Hoover Business Intelligence Unit from The Thompson Corporation. Hoover is a news gathering software agent that comes with a range of information relationships.
- On November 18th, Individual sold its Bookwire division to Cahners Publishing for $1mm. Bookwire is a guide to book-related resources on the Internet that was deemed to be outside of Individual's focus on personalized news services.

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- As of Jan. 10th, Individual's share price has fallen to \$6.125 from the March 15th IPO of \$14.. MS' \$10.5 million investment is worth \$6.4 million.

LIGHTSPAN PARTNERSHIP, INC.

(Financial information shown below is the most recent available)

(in millions)	Actual YTD Sept. 30, 1996	Plan YTD Sept. 30, 1996	Change \$	Change %
Net revenue	\$5.0	\$9.8	(\$4.8)	(49) %
Cost of revenue	3.8	5.9	(2.1)	(36)
Gross profit	1.2	3.9	(2.7)	(69)
Controllable expenses	22.2	24.0	(1.8)	(8)
Net income	(\$21.0)	(\$20.2)	(\$0.8)	NM

- On September 20, 1996. Lightspan raised an additional \$20 million in financing. During this round. MS invested an additional \$1.8 million for 297,619 Series C Preferred stock at \$6 per share. This, in addition to Microsoft's previously invested \$10.1mm for 3.333.333 Series B Preferred Stock at \$3 per share gives Microsoft approximately an 11% stake in the company.
- Delays in delivery of Sony titles have caused Lightspan to downwardly revise its revenue goals for its current FY97 (Jan 97) from \$12 million to \$7 million and in FY98 from \$55 million to \$35 million. Even though the company is accelerating its porting to the Playstation and plans to make expense reductions, the Company expects to run out of cash in April 1997 and plans to raise money in a private placement.
- Lightspan Partnership has 306 employees on payroll. Its mission is to become a major player in the field of interactive multimedia "edutainment" and curricular software targeting the K-6 education market. Lightspan has products on both the Windows and Macintosh platforms. The Lightspan Network. the company's Internet product, was released to Lightspan schools around the country in September 1996.

OTHER INVESTMENTS (LESS THAN \$10 MILLION)

SINGLETRAC ENTERTAINMENT TECHNOLOGIES INC

- On August 28, Microsoft and SingleTrac entered into a Development and Software License Agreement under which SingleTrac will develop up to 10 PC game titles to be published by MS. Microsoft will have exclusive publishing rights to the PC platform.
- At the same time, MS purchased 988,000 shares of Series B Convertible Preferred Stock. for \$4.9 million or \$5.00 per share. These shares represent 26% of SingleTrac's fully diluted shares. MS also has a seat on SingleTrac's Board of Directors.
- SingleTrac is presently working on two titles for Microsoft. Critical Depth will ship for the 1997 holiday season and Dread Naught will ship in March 1998.
- SingleTrac developed two titles for the 1996 holiday season for the Sony PlayStation. Twisted Metal 2 is projected to sell 500,000 units in the US, and Jet Moto is now among the top five selling PSX titles.

VDONET CORP

- On November 6th, VDOnet announced that US West and other investors would invest \$7mm in the Company at a price of \$9.45 per share. This compares with the \$3.84 per share at which Microsoft invested \$5mm on October 28th. US West and NYNEX plan to market the VDOphone to their customers.
- Revenues for the Q97-1 were \$545,000, 118% over plan.
- Based in Israel, VDOnet is a vendor of video networking software for the Internet and Intranet. Its two product lines are VDOLive, a line of client-server software for Internet broadcasting and VDOPhone, an application for video telephony over the Internet and regular telephone lines.

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HELICON PUBLISHING LIMITED

- Revenues of $2.8mm exceeded expectations by over 5% for the seven months ended August due primarily to stronger sales in its Hutchinson Multimedia Encyclopedia 1997 and its Hutchinson Encyclopedia of Music on CD-ROM. Profit at just under $100,000 missed budget due primarily to higher cost of sales and a new accounting policy.
- Helicon has received signed letters from investors willing to invest the remaining US$465,000 to close out the funding the company was seeking during the round of financing in which Microsoft participated. This will take our stake from approximately 48% to approximately 40%, which is what Microsoft originally desired.
- In December 1996, Helicon ended its search for a non-executive chairman with the appointment of Stewart Binnie who has been involved in the UK publishing and retail trade for a number of years.

ACADEMIC SYSTEMS CORPORATION

- In August 1996, Academic Systems completed its Series E Preferred round of financing for $10 million, of which MS committed an additional $1 million for 333,333 shares. Microsoft now owns 1,801,426 Preferred shares for an 8.0% stake in the company.
- The Company has signed a $3.5 million contract licensing Jostens Learning Corporation to distribute and support Interactive Mathematics materials in the high school market over the next two years.
- Academic Systems has installed its products on 41 campuses as of December 31, 1996. The Los Angeles Unified School District, as part of an agreement to work with the Company, has recently agreed to pay Academic Systems $350,000 to develop a prototype for their District. The California State University at Los Angeles has agreed to jointly develop technology-mediated instruction and learning materials with Academic Systems.
- The company is searching for a new CEO to replace Jack Gottsman who resigned in November 1996.

WEBTV NETWORKS, INC.

- On September 13, 1996, MS purchased 702,939 shares of Series C Convertible Preferred Stock of WebTV for $5 million or $7.11 per share. The Series C round raised a total of $34 million. The total post-money value of WebTV was $250 million.
- On September 30, 1996 MS and WebTV announced they had entered into a strategic relationship through which they will collaborate on the development of technologies for delivering Internet browsing over televisions. WebTV will integrate elements of MS Internet Explorer technology, adapted for television display, into a future release of the WebTV browser system.

METRICOM, INCORPORATED

- On December 27, 1996, Ryback Management, a 27.4% shareholder, proposed that shareholders vote to hold a competitive auction for Metricom.
- Revenues for the September quarter were down 26% reflecting a decline in product revenues due to the completion of large contracts. Service revenues increased to $0.7 million from $0.2 million last year. The net loss for the quarter was $10.8 million.

CITRIX SYSTEMS, INC.

- Net revenue for the 3rd quarter ended 9/30 was $11.7 million, up 173% from the prior year. Net income was $5.3 million versus $1.0 million in the year earlier quarter. Growth continued to accelerate driven by demand for the Windows NT-based product, WinFrame.
- During the quarter, Citrix signed an agreement with Sun Microsystems to distribute the ICA protocol in Sun's product line, including its Java implementation.
- MS and Citrix are negotiating an extension of Citrix's NT source code license. MS is very interested in utilizing Citrix's ICA protocols and WinFrame technology to combat network computers (NCs).

MONOTYPE TYPOGRAPHY LIMITED

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- Revenues for the December quarter were down 9% from the prior quarter to $2.1 million and profits were down 50%. The decline is attributed to a strong prior quarter. The fiscal year March 31, 1997 forecast is for revenues of $8.6 million and net income of $0.85 million.
- The company is considering an alliance with AGFA for its retail distribution. This alliance will enable the company to eliminate marketing expenditures.

ASCII NETWORK TECHNOLOGY, INC.

- The company is now profitable. November eleven-month revenues were ¥1.192 million up 50% from last year, and eleven-month income was ¥52 million. In December, ASCII launched a new 24x7 remote maintenance service for PC servers.

VANSTAR CORPORATION

(Financial information shown below is the most recent available.)

(In millions)	Six Months Ended Oct. 31, 1995	Six Months Ended Oct. 31, 1996	Change $	Change %
Net revenue	$763	$953	$190	25 %
Cost of revenue	642	794	152	24
Gross profit	121	159	38	31
Controllable expenses	113	138	25	22
Net income	$8	$21	$13	163

- On May 18, 1995 MS and Vanstar signed a BackOffice Development Agreement, which requires MS to provide Vanstar up to $16 million in marketing development funds over two years. Vanstar will build a nationally deployed systems integration and services business tied to MS's BackOffice product suite, and will hire 400 system engineers by May 1997. MS will recoup the funds through a royalty on revenues generated by Vanstar's system integration business. Vanstar also issued MS warrants to purchase Vanstar common stock.
- On March 11, 1996 Vanstar completed an IPO of 8 million shares at $10 per share. Vanstar is presently trading at $22.375. Microsoft's 1.56 million shares are worth $35 million.
- As of November 30, 1996, Vanstar had hired 303 systems engineers, and 193 had achieved MCSE status.

VERISIGN, INC

- On December 6, 1996 VeriSign closed a $30 million round of private financing from ten strategic partners. MS invested $6.5 million or 22% of the total.
- VeriSign is a certificate authority that authenticates, issues and manages Digital IDs' for customers. Verisign will deliver a secure Internet environment for our customers. Since its founding, VeriSign has issued Digital IDs to more than 10,000 web sites and 400,000 individuals.

ENTEX INFORMATION SERVICES

- On June 24, 1996 Microsoft and Entex signed the Microsoft Office and BackOffice Infrastructure Agreement, whereby Entex will deploy a dedicated team of 150 technicians offering consulting, integration and support services for Microsoft products.
- As of November 30, 1996, Entex had hired 136 technicians who have collectively attained 261 BackOffice certifications.
- To fund this effort, Microsoft loaned Entex $8 million. Microsoft also received a warrant to purchase about 1% of Entex's common shares.

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THE MICROSOFT FAMILY OF FUNDS

During Q95-4, Microsoft's cash investment portfolio was migrated into five distinct sub-portfolios - four fixed-income portfolios and one opportunity portfolio. Each portfolio is a separate mutual fund or risk bucket, with unique guidelines and risk/return expectations. Collectively, the portfolios are the Microsoft "Family of Funds".

With this strategy, MS is increasing the sophistication of our portfolio management efforts, focusing on Total Rate-of-Return portfolio management (as opposed to yield-to-maturity) and using duration as a risk management tool (instead of term-to-maturity).

The goals of this strategy are to:

- Segregate the cash portfolio into individual funds of a more manageable size.
- Enhance the total return on Microsoft's Cash assets.
- Establish risk and return expectations for each Fund.
- Provide pro-active risk management of financial assets.
- Benchmark performance relative to market indices.
- Allow allocation of cash among the various risk segments of the short-term fixed-income market.

Following is a high level summary of the general guidelines of each Fund:

- **Level 1: Money Market Fund**–Designed to meet the operating cash requirements of MS Corporation, and other legal entities, MS MBV, MB IBV, and MS Puerto Rico, this fund has a targeted duration of 20-45 days and a maximum maturity of 91 days. Little principal value fluctuation is expected. Benchmark: 30-Day US Treasury Bill.
- **Level 2: Enhanced Money Market Fund**–Designed as a secondary source of liquidity supporting the Money Market Fund, this fund has a maximum maturity of 13 months. The longer targeted duration of 2-6 months, will provide opportunity for increased return with a modest increase in risk. A small amount of principal value fluctuation is expected. Benchmark: 90-Day US Treasury Bill.
- **Level 3: Short-term Fixed Income Fund**–This fund will carry an increased focus on interest rate changes, security sectors and temporary market anomalies to provide the opportunity for returns above money market rates. Duration is further extended to a target of 1.25 to 2.25 years. Some principal value fluctuation is expected, and negative monthly total returns may occur occasionally. Benchmark: Merrill Lynch US Treasury 1 - 2.99 Yr. Index.
- **Level 4: Intermediate Fixed Income Fund**–An actively managed portfolio with a targeted duration of 2.5 to 4.0 years. This "short bond fund" will focus on the optimal security type, sector, and credit risk to achieve superior returns. Principal value fluctuation is expected. Months with negative returns will occur and an occasional negative quarter is possible. Benchmark: Merrill Lynch US Treasury 3-4.99 Yr. Index.
- **Level 5: Opportunity Fund**–This fund will seek investment opportunities that provide yield enhancement, meet tax-planning objectives, and mirror Microsoft's strategic investments and business relationships. This fund requires senior management approval of each transaction, and does not carry specific maturity constraint.

GENERAL & ADMINISTRATIVE DEFINITIONS:

- For financial reporting, distributions of General & Administrative expenses are made to all domestic groups and are included in people and infrastructure expenses.
- For internal management reports, the net corporate G&A costs are allocated to the channels and product groups as part of corporate allocations.
- ITG costs include application development, regional support, and distributed infrastructure costs. These costs are driven primarily by demand from supported organizations for new technology and tools, support of existing systems, and sales increased demands on the corporate WAN and telecommunications network.
- Human Resources costs are driven primarily by employee headcount. Allocated expenses include employee development, payroll, and stock administration. Distributed HR costs include recruiting and domestic employee benefits such as health insurance, 401(k) match, and health club dues.
- Employee Services group provides administrative support including building services, library services, mail, food and beverage, administrative

procurement, travel services, and copy centers. These costs are driven by user demand and are indirectly correlated to headcount growth.

- Real Estate & Facilities costs include allocated functional costs related to facilities planning and development that are driven primarily by growth in domestic headcount and distributed infra-structure costs such as depreciation, rent, utilities, and maintenance which are driven by the number of employees and contingent staff using MS facilities.
- Finance, legal, and executive costs are corporate functional groups supporting MS on a worldwide basis.

COST OF REVENUE - DEFINITIONS:

- Cost of Revenue includes product costs, royalties, pipe costs and the cost of obsolete and scrapped inventory as described below. The cost of product engineering, configuration and testing prior to release are included as well as the activities of purchasing, manufacturing, and assembling finished goods. In addition, the activities of supply chain management, customer operations, licensing/contract administration, program management, and all the associated costs of IT systems and support are part of cost of revenue.

PRODUCT COSTS

- Standard Product Costs represent both the standard material cost for media, manuals, packaging, hardware and collateral per a Bill of Materials (BOM) for each product as well as labor and overhead expenses stated at the standard burden rate.
- Other Costs include expenses for hardware tooling, prep charges incurred to establish the manufacturing process for a product, cancellation fees, blueline scrap, and recost impacts.
- Purchasing Variances include material purchase price variances (PPV), turnkey PPV, purchase discounts, expediting or change order charges with turnkey vendors, and freight-in and duty/customs expenses incurred to ship raw materials to the location of final assembly or packaging.
- Manufacturing Variances represent manufacturing costs incurred in the internal or external assembly of product which are not included in the standard product cost. This includes operating expenses to manage turnkey vendors, manufacturing absorption variances, material usage variances, BOM variances and variances related to outsourcing packaged product.
- Program Costs and Variances represent the material costs of Select and MSN Upgrade kits as well as any costs incurred for programs such as MSDN or MES Courseware not included in Standard Product Cost. Cost recovery programs such as Tech-net are charged to Marketing Operations.

ROYALTIES

- Royalties include payments to third parties for the right to use intellectual property in MS products.
- The Royalty P&L line item includes both Third Party Royalty payments and the payment or amortization of License Fees.

PIPE COSTS

- Pipe Operations represent all of the operating expenses incurred by an individual pipe or by a worldwide organization in direct support of the various revenue-generating business streams of MS. These operations include primarily Customer Operations (order processing, billing, and collection), Supply Chain Management, Program Management, WW Licensing, and Project Management.
- Distribution represents internal and external costs of picking and packing MS products, including operating expenses of the distribution department, storage costs of finished goods and shipping supplies.
- Central Services represent all of the operating expenses incurred by centralized organizations that provide supporting functions across all pipes. These include IT Expenses, Hardware Operating Expenses, Ops Management/Planning, Supply Base Management, and Product Engineering/Configuration/Release Services.
- Online Telecom consists of network costs for internet connectivity and network access for MSN Subscribers as well as internal expenses for the MSN Network and online Operations groups.
- Online Data Center captures all facilities, maintenance, operational support and staffing of the Online data center including MS internal Data

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Center Operations people and infrastructure costs, and external contracts for facilities and maintenance costs.

- Online Processing is comprised of credit card processing fees, internet advertising tracking and reporting costs, and Financial Operations people and infrastructure expenses for the MSN and online operations groups.

OBSOLETE & SCRAPPED INVENTORY

- Damaged/Obsolete Inventory includes charges for in-house scrap, provision for inventory obsolescence, and cycle count adjustments. Costs included in Damaged/Obsolete Inventory are primarily results of actions by the Regional Operation Service Centers (ROSCs).
- Returns Scrap/Rework includes the material, labor, and overhead of product scrapped and/or reworked and the operating expenses of the returns department and outsourced labor.

CHANNEL COSTS

- Local Customer Operations primarily includes all costs related to fulfillment including programs at both the MS international sales locations and ROSCs. Additionally, this line item includes all customer operations activities (order processing, billing and collection activities) incurred by MS international sales locations.
- Freight includes freight out on finished goods product shipped to customers or subsidiary locations and any related duty and customs charges on importing/exporting of finished product into international subsidiary locations. Freight is net of any reimbursements from customers or distributors.

BUSINESS STREAM DEFINITIONS

- Channel Full Packaged Product (FPP) includes Software FPP , MLPs and Hardware sales. Hardware sales includes both OEM and Retail activity.
- Licensing includes OEM and Retail channel revenue and costs. Retail channel includes Select, MOLP billings and costs include associated disks and documents.
- Programs include subscriptions such as MSDN, Solution Provider and VC++ and fulfillment revenue from products such as supplemental parts and courseware.

KEY PERFORMANCE METRICS

DISTRIBUTED OPERATIONS (PACKAGED PRODUCT)

- Lead Time measures the total number of calendar days from the date of order to customer receipt of all lines of the entire order. It represents a simple average of the lead time for all lines shipped.
- Fill rate is the percentage of total line items filled within the targeted number of calendar days.
- Inventory turnover is measured by taking the annualized total standard product costs of the previous three months and dividing it by the average ending gross inventory balance of the same three months.
- Obsolete and scrapped inventory is measured in aggregate costs and as a percent of net revenue. Costs and net revenue are taken from the finished goods channel management reports

WORLD WIDE LICENSING OPERATIONS

- Operating expenses of the licensing group as a percent of revenue.
- Transactions per head count per month is total financial trasactions (invoices and memos) divided by total regular and temporary headcount.
- Percent accounts receivable current is based on invoice date plus 30 days.
- Processing cost per transaction is measured by dividing the total processing related expenses by the total number of transactions processed.
- Contract and Order cycle times are times, in days, from the receipt of the order to its entry into the licensing system and from the receipt of the order to the processing of the invoice, respectively.

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KEY PRODUCTS RELEASE SCHEDULE

Business Unit/Product	RTM Date Act/Fcst	RTM Date Plan
Desktop Finance:		
Money 98	Aug-97	Aug-97
Investor 3.0	Feb-97	Feb-97
Investor 4.0	May-97	May-97
Interactive Media		
Wine Guide 2.0	Jul-96	Jun-96
Car Point 1.1	Jul-96	Apr-96
Cinemania 97	Jul-96	Jun-96
Explorapedia Transportation	Jul-96	Jul-96
Music Central 2.0	Jul-96	Jun-96
Deadly Tide	Jul-96	Jul-96
High Score Upload	Jul-96	Aug-96
Interactive Music Archive 2.0	Jul-96	Jul-96
Monster Truck Madness	Jul-96	Jul-96
MSB-Rex	Jul-96	Jul-96
Battlemaster	Aug-96	Aug-96
Creative Writer 2.0	Aug-96	Aug-96
Nick	Aug-96	Jul-96
Online Chess	Aug-96	Aug-96
Automap Streets Plus	Aug-96	Aug-96
Encarta 97 Encyclopedia	Aug-96	Aug-96
Encarta 97 World Atlas	Aug-96	Aug-96
NBA Full Court Press	Aug-96	Aug-96
B3 Substitute	Aug-96	Aug-96
Explorapedia Arts & Entertainment	Aug-96	Aug-96
MSN Version 2.0	Sep-96	Sep-96
IntelliMouse (Magellan)	Sep-96	May-96
Ultimate Climb	Sep-96	Sep-96
Kids Online GameSpace	Sep-96	Aug-96
Mango 97	Sep-96	Sep-96
Spike's World	Sep-96	Sep-96
GEX	Sep-96	Sep-96
Golf 3.0	Sep-96	Aug-96
Automap Trip Planner	Sep-96	Jul-96
Chalk Talk: Cooper McCue Breaks Through! (DWI)	Sep-96	Sep-96
CyberChef: Let's Get Cookin (DWI)	Sep-96	Sep-96
Flight Simulator 6.0	Sep-96	Sep-96
Goosebumps: Escape from Horrorland (DWI)	Sep-96	Sep-96
Soccer	Sep-96	Sep-96
Electronic Travel Agent (Expedia)	Sep-96	Sep-96
Hellbender	Sep-96	Aug-96
MSB Solar System	Sep-96	Sep-96
Hardware		
IntelliMouse (Magellan)	Sep-96	Oct-96
Serial Mouse (Maui)	Nov-96	Nov-96
Sidewinder 3DPro for Mac	Jan-97	Jan-97
PS/2 and Serial Mouse (Greyhound)	Feb-97	Feb-97

Business Unit/Product	RTM Date Act/Fcst	RTM Date Plan
Desktop Applications:		
FrontPage 97	Nov-96	Nov-96
Win Publisher 97	Oct-96	Oct-96
Team Manager	Oct-96	Apr-96
Win Office 97	Dec-96	Oct-96
Win Office Pro 97	Dec-96	Oct-96
Outlook (stand alone application)	Jan-97	Oct-96
Mac Office 97	Sep-97	Sep-97
Desktop & Business Systems:		
MS Proxy Server 1.0	Oct-96	Apr-96
SNA Server 3.0	Nov-96	Sep-96
BackOffice 2.5	Nov-96	Nov-96
Index Server 1.1	Nov-96	Nov-96
Internet Information Server 3.0	Dec-96	Dec-96
Transaction Server 1.0	Dec-96	Nov-96
MS Exchange Server 5.0	Mar-97	Nov-96
"Wolfpack" 1.0	Jun-97	Jun-97
MS Commercial Internet System	Dec-96	Jan-97
Merchant Server	Nov-96	Nov-96
Softimage:		
Twister	Sep-97	Sep-97
Digital Studio NT 1.0	Jun-97	Dec-96
Softimage 3D 3.7 NT/Irix	Mar-97	Mar-97
Softimage 3D 3.5 NT	Aug-96	Aug-96
Eddie 3.5	Feb-97	Sep-96
Consumer Platforms:		
Handheld PC V1.0	Aug-96	Aug-96
Handheld PC V2.0	Sep-97	Sep-97
Entertainment Pack for Windows CE	Jan-97	Dec-96
VC++ for Windows CE	Feb-97	Feb-97
Windows CE OAK	Mar-97	Mar-97
Broadcast PC	Jun-97	Mar-97
Internet Platforms		
MSDN Universal	Jul-96	Jul-96
Visual FoxPro 5.0	Aug-96	Jul-96
Visual J++	Sep-96	Jul-96
Internet Explorer 3.0	Aug-96	Aug-96
SourceSafe 5.0	Oct-96	Oct-96
Visual Basic 5.0	Mar-97	Oct-96
Internet Explorer 4.0	Jul-97	Nov-96
Visual Interdev (Internet Studio)	Mar-97	Nov-96
Visual C++ 5.0	Mar-97	Nov-96
Multipoint Data Server	Oct-97	Apr-97
NetShow	Dec-96	
Tiger Server	Aug-97	Apr-97

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Q97-2 WORLDWIDE REVENUE SUMMARY

(Revsum categories, $ in thousands except Revenue/License)

	Revenue			Licenses				Revenue / License			FY97 USEG YTD	
	Actual	Var to Budget	Var %	Actual	Var to Budget	Var %	CALs**	Actual	Var to Bud	Var %	Licenses	Rev/Lic
Office (Full Pkg Product)	80,623	(6,172)	(7%)	216,803	(20,640)	(9%)	-	372	6	2%	141,890	406
Office (MLP)	19,161	(5,402)	(22%)	54,986	(18,364)	(25%)	-	348	14	4%	34,049	346
Office (MOLP)	52,983	12,980	32%	182,132	34,193	23%	-	291	21	8%	43,882	320
Office (Select/OEM/Other)	126,640	(14,394)	(10%)	626,027	(513,841)	(45%)	-	202	79	63%	247,735	217
Office (Academic-FPP/MLP)	8,936	(2,994)	(25%)	71,120	(24,295)	(25%)	-	126	1	0%	97,842	110
Office (Academic-MOLP/Select/Other)	7,014	1,771	34%	110,350	15,827	17%		64	8	15%	84,518	35
Office - Standard Product	295,359	(14,212)	(5%)	1,261,418	(527,120)	(29%)		234	61	35%	649,916	232
Office Professional (Full Pkg Product)	102,752	15,579	18%	243,083	37,791	18%	-	423	(2)	(0%)	142,524	488
Office Professional (MLP)	21,093	(1,442)	(6%)	67,146	(1,841)	(3%)	-	314	(13)	(4%)	30,226	414
Office Professional (MOLP)	35,138	6,516	23%	117,703	15,278	15%		299	19	7%	39,188	384
Office Professional (Select/OEM/Other)	151,951	94,669	165%	1,128,632	847,430	301%		135	(66)	(33%)	283,605	219
Office Professional (Academic-FPP/MLP)	28,346	3,847	16%	200,504	19,591	11%	-	141	6	4%	387,495	133
Office Professional (Academic-MOLP/Select/Other)	13,872	3,672	36%	214,425	46,312	28%	-	65	4	7%	257,340	44
Office Professional - Standard Product	353,153	122,841	53%	1,971,493	964,561	96%	-	179	(50)	(22%)	1,140,378	195
Excel	30,274	(793)	(3%)	295,499	(19,468)	(6%)	-	102	4	4%	67,111	171
Word/Excel Bundle	38,086	5,566	17%	430,700	44,297	11%	-	88	4	5%	-	-
Word	44,468	1,090	3%	528,754	32,363	7%	-	84	(3)	(4%)	91,428	168
Power Point	5,801	(319)	(5%)	54,115	18,429	52%	-	107	(64)	(37%)	34,483	122
Access	20,556	(834)	(4%)	137,425	(31,219)	(19%)	-	150	23	18%	92,198	177
Project	45,610	(7,082)	(13%)	167,005	(47,587)	(22%)	-	273	28	11%	170,330	272
Works*	35,122	3,087	10%	3,146,166	182,607	6%	-	11	0	3%	247,916	29
Publisher*	24,088	9,842	69%	889,749	520,066	141%	-	27	(11)	(30%)	347,106	57
Greetings Workshop	4,659	2,703	138%	256,236	171,227	201%	-	18	(5)	(21%)	280,112	18
Picture It	6,061	3,386	127%	100,196	54,866	121%	-	60	1	3%	87,788	60
FrontPage*	12,277	7,915	181%	125,502	82,864	194%	-	98	(4)	(4%)	162,581	105
Other Desktop Apps	8,977	6,977	349%	668,074	621,284	1328%	-	13	(29)	(69%)	43,637	(58)
Desktop Apps - Standard Product	924,489	140,168	18%	10,032,332	2,067,170	26%	-	92	(6)	(6%)	3,414,984	152
Office (Full Pkg Product)	68,735	3,756	6%	307,847	18,903	7%	-	223	(2)	(1%)	240,271	209
Office (MLP)	3,803	(1,415)	(27%)	18,986	(6,890)	(27%)	-	200 #	(1)	(1%)	10,198	204
Office (MOLP)	27,623	8,332	43%	154,627	51,428	50%	-	179	(8)	(4%)	44,116	181
Office (Select/OEM/Other)	43,283	11,669	37%	332,283	86,367	35%	-	130	2	1%	184,688	125
Home Essentials*	1,433	(3,161)	(69%)	26,140	(10,400)	(28%)	-	55	(71)	(56%)	91,008	69
Small Business Edition*	497	(12,972)	(96%)	1,340	(504,701)	(100%)	-	371	345	1294%	-	-
Office - Upgrades	145,375	6,209	4%	841,223	(365,293)	(30%)	-	173	57	50%	570,281	157
OfficePro/Intellimouse Bundle	23,982	19,333	416%	77,703	60,492	351%	-	309	38	14%	60,336	305
Office Professional (Full Pkg Product)	78,281	17,360	28%	263,815	52,460	25%	-	297	8	3%	213,032	285
Office Professional (MLP)	3,723	(1,557)	(29%)	13,615	(8,849)	(39%)	-	273	38	16%	12,215	275
Office Professional (MOLP)	16,914	4,289	34%	71,576	15,940	29%	-	236	9	4%	40,899	240
Office Professional (Select/OEM/Other)	28,970	4,324	18%	206,734	36,186	21%	-	140	(4)	(3%)	210,778	135
Office Professional - Upgrades	151,870	43,749	40%	633,443	156,229	33%	-	240	13	6%	537,260	225
Excel	8,707	(3,368)	(28%)	93,788	(38,498)	(29%)	-	93	2	2%	50,038	89
Word	11,983	(5,052)	(30%)	161,622	(25,700)	(14%)	-	74	(17)	(18%)	141,641	69
Power Point	567	(895)	(61%)	6,458	(9,398)	(59%)	-	88	(4)	(5%)	3,156	104
Access	3,888	(3,360)	(46%)	40,168	(40,257)	(50%)	-	97	7	7%	53,455	90

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Q97-2 Worldwide Revenue Summary

(Revsum categories, $ in thousands except Revenue/License

	Revenue			Licenses				Revenue / License			FY97 USLG YTD	
	Actual	Var to Budget	Var %	Actual	Var to Budget	Var %	CALs**	Actual	Var to Bud	Var %	Licenses	Rev/Lic
Project	2,475	(3,765)	(60%)	21,967	(32,746)	(60%)	-	113	(1)	(1%)	27,047	110
Other Desktop Apps	9	(53)	(85%)	99	(2,295)	(96%)	-	96	69	265%	38	66
Desktop Apps - Upgrades	324,873	33,466	11%	1,798,768	(357,958)	(17%)		181	45	34%	1,382,916	108
DAD Recognized Maintenance	111,832	14,447	15%	1,347,893	303,750	29%		n/a	n/a	n/a	1,175,562	n/a
Desktop Apps - Total	1,361,194	188,081	16%	13,178,993	2,012,962	18%		103	(3)	(3%)	5,973,162	115
Kids	14,759	(10,590)	(42%)	1,796,211	504,933	39%		8	(11)	(58%)	896,988	16
Entertainment	76,173	18,731	33%	3,820,844	1,397,270	58%		20	(1)	(10%)	1,195,551	31
Personal Interests	5,254	(4,124)	(44%)	807,901	306,787	61%		7	(12)	(65%)	71,625	8
Geo	13,335	559	4%	347,431	(17,335)	(5%)		38	3	10%	180,077	35
Travel	57	(1,142)	(95%)	-					-	-		
Health	-	-	-	-								
Reference	48,780	7,276	18%	2,441,155	718,013	42%		20	(4)	(17%)	131,529	16
Cityscape	-	-	-	-	-	-	-	-	-		-	
Decision Reference	-	(308)	(100%)	-	-	-	-	-	-	-	-	-
MSN - Subscriptions	52,574	5,454	12%	6,413,298	900,927	16%	-	8	(0)	(4%)	-	-
MSN - Transactions	783	690	743%	-	-	-	-	-	-	-	-	-
MSN - Advertising	1,189	(5,403)	(82%)	-	-	-	-	-	-	-	-	-
Other Interactive Media	12,308	6,301	105%	365,457	153,157	72%	-	34	5	19%	265,177	32
Interactive Media	225,212	17,445	8%	15,992,297	3,963,752	33%	-	14	(3)	(18%)	2,900,747	31
Keyboards	14,166	(9,903)	(41%)	248,970	(187,682)	(43%)	-	57	2	3%	125,447	76
Mouse/Ballpoint	86,914	(774)	(1%)	5,870,683	892,790	18%	-	15	(3)	(16%)	909,591	43
Gaming Devices	32,507	932	3%	850,185	25,408	3%	-	38	(0)	(0%)	447,331	41
Other Consumer Input Devices	249	249	-	146,986	146,986	-	-	2	2	-	-	-
Consumer Input Devices	133,836	(9,495)	(7%)	7,116,824	877,502	14%	-	19	(4)	(18%)	1,482,369	45
Desktop Finance	10,813	2,282	27%	1,500,561	600,340	67%	-	7	(2)	(24%)	139,424	22
Total Apps/Content	1,731,055	198,312	13%	37,788,675	7,454,556	25%	-	46	(5)	(9%)	10,496,002	98
MS-DOS	57,095	777	1%	3,132,373	242,094	8%	-	18	(1)	(6%)	209,524	33
Windows, WfW	85,040	1,642	2%	2,960,467	113,026	4%	-	29	(1)	(2%)	405,906	44
Windows 95	731,760	148,423	25%	13,153,681	2,148,319	20%	-	56	3	5%	1,846,175	79
Windows NT Workstation - Standard	131,110	40,570	45%	888,753	170,809	24%	-	148	21	17%	463,546	154
Windows NT Workstation - Upgrades	29,710	17,784	149%	278,271	153,784	124%	-	107	11	11%	287,642	102
Other Desktop Systems	5,760	2,815	96%	546,992	477,000	682%	-	11	(32)	(75%)	3,671	23
Desktop Systems Recognized Maintenance	53,971	24,921	86%	1,130,063	763,497	208%	-	48	(31)	(40%)	965,616	58
Desktop Systems	1,094,445	236,932	28%	22,090,600	4,068,529	23%	-	50	2	4%	4,182,080	78
Windows NT CALs	36,220	12,906	55%	1,842,824	631,562	52%	-	20	0	2%	1,245,397	17
Windows NT Servers - Standard	108,691	22,643	26%	203,522	27,560	16%	648,230	534	45	9%	126,665	511
Windows NT Servers - Upgrades	20,980	13,616	185%	64,174	35,881	127%	320,940	327	67	26%	48,623	351
SQL CALs	10,974	(4,642)	(30%)	133,153	(63,739)	(32%)	-	82	3	4%	116,895	79
SQL Servers - Standard	20,736	2,041	11%	21,243	(4,228)	(17%)	89,345	976	242	33%	16,847	977
SQL Servers - Upgrades	1,691	(400)	(19%)	4,370	(3,256)	(43%)	-	387	113	41%	3,272	375
Exchange CALs	16,214	9,131	129%	400,568	227,161	131%	-	40	(0)	(1%)	336,788	38
Exchange Servers	12,736	(22,782)	(64%)	11,272	(18,093)	(62%)	93,555	1,130	(80)	(7%)	8,344	1,284
Backoffice CALs	32,516	16,368	101%	305,252	148,079	94%	-	107	4	4%	291,623	103
Backoffice Servers	16,699	1,425	9%	13,933	(411)	(3%)	40	1,199	134	13%	11,173	1,255
Small Business Servers	-	(299)	(100%)	-	(322)	(100%)	-	-	(938)	(100%)	-	-

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Q97-2 WORLDWIDE REVENUE SUMMARY

(Revsum categories, $ in thousands except Revenue/License

	Revenue			Licenses				Revenue / License			FY97 [illegible] YTD	
	Actual	Var to Budget	Var %	Actual	Var to Budget	Var %	CALs**	Actual	Var to Bud	Var %	Licenses	Rev/Lic
Mail Clients	963	(174)	(15%)	28,466	(12,199)	(30%)	-	34	6	21%	38,222	32
Mail Servers	2,562	(261)	(9%)	7,780	(1,283)	(14%)	(4)	329	18	6%	8,558	309
Mail AddIns	7,819	1,843	31%	89,781	33,724	60%	-	87	(20)	(18%)	78,786	89
SMS CALs	11,890	1,879	19%	433,077	24,938	6%	-	27	3	12%	358,513	25
SMS Servers	3,883	79	2%	10,712	1,126	12%	13,445	363	(34)	(9%)	7,682	329
SNA CALs	3,700	182	5%	108,201	7,643	8%	-	34	(1)	(2%)	85,636	33
SNA Servers	2,124	84	4%	7,263	(1,636)	(18%)	4,575	292	63	28%	5,125	250
Internet CALs	-	(496)	(100%)	-	(56,595)	(100%)	-	-	(9)	(100%)	-	-
Internet Servers	1,625	(1,969)	(55%)	2,467	(5,436)	(69%)		659	204	45%	1,344	579
Other Business Systems	27,825	1,683	6%	141,973	95,996	209%	-	196	(373)	(66%)	141,370	213
Business Systems Recognized Maintenance	18,199	5,271	41%	1,458,845	990,944	212%	-	12	(15)	(55%)	1,291,426	14
Business Systems	358,044	58,127	19%	5,288,876	2,057,416	64%	1,192,000	68	(25)	(27%)	4,222,289	65
Desktop and Business Systems - Total	1,452,490	295,060	25%	27,379,476	6,125,945	29%	1,192,000	53	(1)	(3%)	8,404,369	71
Visual Basic	29,507	(13,132)	(31%)	166,147	(73,218)	(31%)	-	178	(1)	(0%)	170,499	124
C++	24,958	242	1%	124,657	14,183	13%	-	200	(24)	(11%)	116,457	164
Visual J++	5,609	1,225	28%	77,896	39,701	104%	-	72	(43)	(37%)	53,070	69
Internet Studio	-	(2,231)	(100%)	-	(10,856)	(100%)	-	-	(206)	(100%)	-	-
Fox	5,569	(4,765)	(46%)	31,842	(11,009)	(26%)	-	175	(66)	(27%)	32,212	180
Developer Office	-	(291)	(100%)	-	(453)	(100%)	-	-	(641)	(100%)	-	-
MSDN	26,059	6,046	30%	40,945	(545)	(1%)	-	636	154	32%	37,921	704
Office Developers Technologies	5,092	(4,058)	(44%)	14,803	(22,024)	(60%)	-	344	96	38%	10,375	304
SourceSafe	3,054	585	24%	10,956	(347)	(3%)	-	279	60	28%	11,981	277
MS Mastering	4,885	(2,146)	(31%)	33,312	(55,308)	(62%)	-	147	67	85%	45,296	133
MS Plus!	12,248	1,747	17%	1,341,722	1,070,341	394%	-	9	(30)	(76%)	301,848	36
Other Internet Platform and Tools	6,389	(4,370)	(41%)	344,923	236,255	217%	-	19	(80)	(81%)	106,734	53
Internet Platform and Tools	123,372	(21,147)	(15%)	2,187,203	1,186,720	119%	-	56	(88)	(61%)	886,393	119
SoftImage	9,342	1,028	12%	17,450	15,267	699%	-	535	(3,273)	(86%)	-	-
Consumer Platform	-	-	-	-	-	-	-	-	-	-	-	-
Total Platforms	1,585,204	274,941	21%	29,584,129	7,327,932	33%	1,192,000	54	(5)	(9%)	9,290,762	76
Total Product Group	3,316,259	473,253	17%	67,372,804	14,782,488	28%	1,192,000	49	(5)	(9%)	19,786,764	87
Press	26,468	722	3%	-	-	-	-	-	-	-	-	-
Other (Mac, MHS, Xenix, OS2)	69,069	37,864	121%	2,639,919	2,225,927	538%	281,162	26	(49)	(65%)	293,380	71
Gross Revenue	3,411,795	511,838	18%	70,012,723	17,008,415	32%	1,473,252	49	(6)	(11%)	20,080,144	87

* *Line item includes both Standard and Upgrade revenue.*

***Bundled CALs indicate client licenses bundled with server products. Not included in Rev/Lic calculation.*

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FY97 YTD WORLDWIDE REVENUE SUMMARY

(Revsum categories, $ in thousands except Revenue/License)

	Revenue			Licenses				Revenue / License			FY97 USTG YTD	
	Actual	Var to Budget	Var %	Actual	Var to Budget	Var %	CALs**	Actual	Var to Bud	Var %	Licenses	Rev/Lic
Office (Full Pkg Product)	145,349	(13,783)	(9%)	403,633	(40,176)	(9%)	.	360	2	0%	141,890	406
Office (MLP)	40,191	(5,533)	(12%)	119,009	(18,750)	(14%)	.	338	6	2%	31,049	346
Office (MOLP)	88,391	15,787	22%	309,092	38,343	14%		286	18	7%	43,882	320
Office (Select/OEM/Other)	224,035	(46,612)	(17%)	1,122,444	(1,093,473)	(49%)	.	200	77	63%	247,735	217
Office (Academic-FPP/MLP)	20,941	(1,377)	(6%)	168,493	(14,394)	(8%)	.	124	2	2%	97,842	110
Office (Academic-MOLP/Select/Other)	13,097	3,537	37%	219,920	41,721	23%		60	6	11%	81,518	35
Office - Standard Product	532,003	(47,980)	(8%)	2,342,591	(1,086,729)	(32%)	.	227	58	34%	643,916	232
Office Professional (Full Pkg Product)	193,094	34,619	22%	471,582	98,285	26%	.	409	(15)	(4%)	142,524	488
Office Professional (MLP)	42,568	(989)	(2%)	132,066	(3,700)	(3%)		322	1	0%	30,226	414
Office Professional (MOLP)	64,384	12,140	23%	216,212	27,787	15%	.	298	21	7%	39,188	384
Office Professional (Select/OEM/Other)	254,525	144,410	131%	1,863,267	1,317,955	242%	.	137	(65)	(32%)	283,605	219
Office Professional (Academic-FPP/MLP)	68,381	20,287	42%	496,444	137,161	38%		138	4	3%	387,495	133
Office Professional (Academic-MOLP/Select/Other)	28,117	8,694	45%	450,879	124,486	38%	.	62	3	5%	257,340	44
Office Professional - Standard Product	651,069	219,162	51%	3,630,450	1,701,974	88%	.	179	(45)	(20%)	1,140,378	195
Excel	56,213	(451)	(1%)	540,111	(33,790)	(6%)	.	104	5	5%	67,111	171
Word/Excel Bundle	62,018	(565)	(1%)	700,641	(67,514)	(9%)	.	89	7	9%	-	-
Word	78,201	(632)	(1%)	923,626	17,203	2%		85	(2)	(3%)	91,428	168
Power Point	9,968	(1,587)	(14%)	84,137	15,366	22%	.	118	(50)	(29%)	34,483	122
Access	40,929	456	1%	284,007	(36,727)	(11%)	.	144	18	14%	92,198	177
Project	87,597	(11,992)	(12%)	310,450	(101,011)	(25%)	.	282	40	17%	170,330	272
Works*	59,092	(519)	(1%)	5,112,543	(503,683)	(9%)	.	12	1	9%	247,916	29
Publisher*	36,857	11,946	48%	1,424,882	748,341	111%	.	26	(11)	(30%)	347,106	57
Greetings Workshop	5,867	2,819	93%	319,588	183,861	135%	.	18	(4)	(18%)	280,112	18
Picture It	6,061	712	13%	100,196	9,536	11%		60	1	3%	87,788	60
FrontPage*	24,438	16,954	227%	228,419	153,614	205%		107	7	7%	162,581	105
Other Desktop Apps	9,703	5,687	142%	1,080,588	969,987	877%	.	9	(27)	(75%)	43,637	(58)
Desktop Apps - Standard Product	1,660,014	194,008	13%	17,082,229	1,970,458	13%	.	97	0	0%	3,414,984	152
Office (Full Pkg Product)	112,542	(3,413)	(3%)	500,408	(17,209)	(3%)	.	225	1	0%	240,271	209
Office (MLP)	6,965	(2,503)	(26%)	33,549	(13,533)	(29%)	.	208	7	3%	10,198	204
Office (MOLP)	43,075	8,568	25%	235,885	51,600	28%	.	183	(5)	(2%)	44,116	181
Office (Select/OEM/Other)	72,126	14,273	25%	534,015	86,109	19%	.	135	6	5%	184,688	125
Home Essentials*	6,611	(2,021)	(23%)	95,203	26,039	38%	.	69	(55)	(44%)	91,008	69
Small Business Edition*	497	(24,126)	(98%)	1,340	(892,280)	(100%)	.	371	344	1247%	-	-
Office - Upgrades	241,816	(9,223)	(4%)	1,400,400	(759,274)	(35%)	.	173	56	49%	570,281	157
OfficePro/Intellimouse Bundle	23,982	14,665	157%	77,703	43,099	125%	.	309	39	15%	60,336	305
Office Professional (Full Pkg Product)	128,041	17,190	16%	437,514	48,163	12%	.	293	8	3%	213,032	285
Office Professional (MLP)	6,998	(3,341)	(32%)	25,843	(19,493)	(43%)	.	271	43	19%	12,215	275
Office Professional (MOLP)	27,642	4,446	19%	116,262	10,865	10%	.	238	18	8%	40,899	240
Office Professional (Select/OEM/Other)	50,838	6,293	14%	368,382	60,006	19%	.	138	(6)	(4%)	210,778	135
Office Professional - Upgrades	237,502	39,254	20%	1,025,704	142,640	16%	.	232	7	3%	537,260	225
Excel	13,996	(7,998)	(36%)	149,321	(93,211)	(38%)	.	94	3	3%	50,038	89
Word	24,798	(6,113)	(20%)	309,025	(32,516)	(10%)	.	80	(10)	(11%)	141,641	69
Power Point	755	(1,949)	(72%)	7,782	(21,556)	(73%)	.	97	5	5%	3,156	104
Access	8,155	(5,593)	(41%)	85,199	(69,350)	(45%)	.	96	7	8%	53,455	90

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FY97 YTD WORLDWIDE REVENUE SUMMARY (CONTINUED)

(Revsum categories, $ in thousands except Revenue/License)

	Revenue			Licenses				Revenue / License			FY97 US SEG YTD	
	Actual	Var to Budget	Var %	Actual	Var to Budget	Var %	CALs**	Actual	Var to Bud	Var %	Licenses	Rev/Lic
Project	4,868	(6,899)	(59%)	42,471	(61,154)	(59%)	-	115	1	1%	27,047	110
Other Desktop Apps	11	(93)	(89%)	125	(3,864)	(97%)	-	91	65	247%	38	66
Desktop Apps - Upgrades	531,901	1,386	0%	3,020,027	(898,285)	(23%)	-	176	41	30%	1,382,916	168
DAD Recognized Maintenance	193,594	20,397	12%	2,384,952	377,361	19%	-	n/a	n/a	n/a	1,175,562	n/a
Desktop Apps - Total	2,385,509	215,791	10%	22,487,208	1,449,534	7%	-	106	3	3%	5,973,462	145
Kids	22,932	(13,610)	(37%)	2,691,677	744,216	38%	-	9	(10)	(55%)	456,988	16
Entertainment	96,640	28,385	42%	5,427,485	2,124,342	64%	-	18	(3)	(14%)	1,495,551	31
Personal Interests	8,730	(4,801)	(35%)	1,328,889	557,847	72%		7	(11)	(63%)	71,625	8
Geo	18,810	2,341	14%	512,066	21,673	4%	-	37	3	9%	180,077	35
Travel	57	(1,142)	(95%)	-	-	-	-	-	-	-	-	-
Health	-	-	-	-	-	-	-	-	-	-	-	-
Reference	62,279	4,577	8%	3,411,271	691,221	25%	-	18	(3)	(14%)	411,329	46
Cityscape	-	-	-	-	-	-	-	-	-	-	-	-
Decision Reference	8	(429)	(98%)	2,124	2,124	-	-	4	4	-	-	-
MSN - Subscriptions	68,895	(14,056)	(17%)	8,215,359	(1,283,873)	(14%)	-	8	(0)	(4%)	-	-
MSN - Transactions	909	768	544%	-	-	-	-	-	-	-	-	-
MSN - Advertising	2,310	(7,577)	(77%)	-	-	-	-	-	-	-	-	-
Other Interactive Media	12,147	5,934	96%	358,302	139,250	64%	-	34	6	20%	265,177	32
Interactive Media	293,717	391	0%	21,947,173	2,996,800	16%	-	13	(2)	(14%)	2,900,747	31
Keyboards	25,286	(11,934)	(32%)	455,059	(245,525)	(35%)	-	56	2	5%	125,447	76
Mouse/Ballpoint	148,236	9,201	7%	10,202,721	1,743,729	21%	-	15	(2)	(12%)	909,591	43
Gaming Devices	39,916	(4,251)	(10%)	1,004,155	(139,644)	(12%)	-	40	1	3%	447,331	41
Other Consumer Input Devices	267	267	-	154,218	154,218	-	-	2	2	-	-	-
Consumer Input Devices	213,705	(6,717)	(3%)	11,816,153	1,512,778	15%	-	18	(3)	(15%)	1,482,369	45
Desktop Finance	12,786	1,088	9%	2,298,317	767,039	50%	-	6	(2)	(27%)	139,424	22
Total Apps/Content	2,905,716	210,553	8%	58,548,851	6,726,151	13%	-	50	(2)	(5%)	10,496,002	98
MS-DOS	122,791	10,460	9%	7,017,002	1,161,274	20%	-	17	(2)	(9%)	209,524	33
Windows, WfW	172,993	11,907	7%	6,209,638	352,899	6%	-	28	0	1%	405,906	44
Windows 95	1,289,310	269,262	26%	23,326,174	3,905,544	20%	-	55	3	5%	1,846,175	79
Windows NT Workstation - Standard	216,163	76,401	55%	1,455,834	381,806	36%	-	148	18	14%	463,546	154
Windows NT Workstation - Upgrades	54,496	35,489	187%	511,506	311,507	156%	-	107	12	12%	287,642	102
Other Desktop Systems	11,849	6,910	140%	1,355,605	1,217,221	880%	-	9	(27)	(76%)	3,671	23
Desktop Systems Recognized Maintenance	88,782	34,522	64%	1,823,611	1,121,650	160%	-	49	(29)	(37%)	965,616	58
Desktop Systems	1,956,385	444,950	29%	41,699,370	8,451,901	25%	-	47	1	3%	4,182,080	78
Windows NT CALs	63,316	21,128	50%	3,255,842	1,039,761	47%	-	19	0	2%	1,245,397	17
Windows NT Servers - Standard	198,494	55,137	38%	371,998	79,436	27%	1,207,435	534	44	9%	126,665	511
Windows NT Servers - Upgrades	38,605	24,566	175%	113,788	60,777	115%	615,240	339	74	28%	48,623	351
SQL CALs	21,803	(6,920)	(24%)	261,564	(118,595)	(31%)	-	83	8	10%	116,895	79
SQL Servers - Standard	41,857	9,331	29%	43,830	(488)	(1%)	171,970	955	221	30%	16,847	977
SQL Servers - Upgrades	3,579	(548)	(13%)	8,966	(7,936)	(47%)	-	399	155	63%	3,272	375
Exchange CALs	24,052	11,656	94%	597,130	294,068	97%	-	40	(1)	(2%)	336,788	38
Exchange Servers	27,876	(37,533)	(57%)	23,351	(29,751)	(56%)	226,630	1,194	(38)	(3%)	8,344	1,284
Backoffice CALs	55,699	26,778	93%	504,856	210,817	72%	-	110	12	12%	291,623	103
Backoffice Servers	37,461	10,526	39%	32,032	6,214	24%	40	1,169	126	12%	11,173	1,255
Small Business Servers	-	(537)	(100%)	-	(558)	(100%)	-	-	(963)	(100%)	-	-

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FY97 YTD WORLDWIDE REVENUE SUMMARY (CONTINUED)

(Revsum categories, $ in thousands except Revenue/License)

	Revenue			Licenses				Revenue / License			FY97 USEG YTD	
	Actual	Var to Budget	Var %	Actual	Var to Budget	Var %	CALs**	Actual	Var to Bud	Var %	Licenses	Rev/Lic
Mail Clients	2,344	57	3%	69,813	(12,637)	(15%)	-	34	6	21%	38,222	32
Mail Servers	6,305	382	6%	19,898	1,149	6%	160	317	1	0%	8,558	309
Mail AddIns	16,480	4,632	39%	228,851	116,564	104%	-	72	(33)	(32%)	78,786	89
SMS CALs	20,554	2,893	16%	769,632	45,926	6%	-	27	2	9%	358,513	25
SMS Servers	7,074	9	0%	19,153	1,138	6%	19,935	369	(23)	(6%)	7,682	329
SNA CALs	7,228	1,523	27%	217,219	52,527	32%	-	33	(1)	(3%)	85,636	33
SNA Servers	3,331	(49)	(1%)	12,056	(2,785)	(19%)	4,501	276	49	21%	5,125	250
Internet CALs	-	(561)	(100%)	-	(62,773)	(100%)	-	-	(9)	(100%)	-	-
Internet Servers	1,625	(2,449)	(60%)	2,467	(6,511)	(73%)	-	659	205	45%	1,344	579
Other Business Systems	52,179	(566)	(1%)	265,788	164,674	163%		196	(325)	(62%)	141,370	213
Business Systems Recognized Maintenance	30,627	6,566	27%	2,244,044	1,402,269	167%		14	(15)	(52%)	1,291,426	14
Business Systems	660,487	126,021	24%	9,062,278	3,233,286	55%	2,245,911	73	(19)	(21%)	4,222,289	65
Desktop and Business Systems - Total	2,616,873	570,971	28%	50,761,648	11,685,187	30%	2,245,911	52	(1)	(2%)	8,404,369	71
Visual Basic	59,652	(7,744)	(11%)	336,928	(41,804)	(11%)	-	177	(1)	(1%)	170,499	124
C++	50,699	2,449	5%	269,479	53,108	25%	-	188	(35)	(16%)	116,457	164
Visual J++	7,131	266	4%	100,259	40,829	69%	-	71	(44)	(38%)	53,070	69
Internet Studio	-	(2,431)	(100%)	-	(11,747)	(100%)	-	-	(207)	(100%)	-	-
Fox	11,897	(6,858)	(37%)	65,267	(11,570)	(15%)	-	182	(62)	(25%)	32,212	180
Developer Office	-	(496)	(100%)	-	(779)	(100%)	-	-	(637)	(100%)	-	-
MSDN	49,666	9,899	25%	73,484	(7,115)	(9%)	-	676	182	37%	37,921	704
Office Developers Technologies	10,146	(2,494)	(20%)	31,150	(19,669)	(39%)	-	326	77	31%	10,375	304
SourceSafe	5,182	633	14%	18,036	(2,992)	(14%)	-	287	71	33%	11,981	277
MS Mastering	9,445	(1,078)	(10%)	64,298	(67,870)	(51%)	-	147	67	84%	45,296	133
MS Plus!	25,686	3,537	16%	2,140,126	358,761	20%	-	12	(0)	(3%)	301,848	36
Other Internet Platform and Tools	14,473	(3,381)	(19%)	497,168	317,472	177%	-	29	(70)	(71%)	106,734	53
Internet Platform and Tools	243,977	(7,697)	(3%)	3,596,195	606,624	20%	-	68	(16)	(19%)	886,393	119
SoftImage	17,451	1,674	11%	26,748	22,564	539%	-	652	(3,118)	(83%)	-	-
Consumer Platform	-	-	-	-	-	-	-	-	-	-	-	-
Total Platforms	2,878,301	564,948	24%	54,384,591	12,314,375	29%	2,245,911	53	(2)	(4%)	9,290,762	76
Total Product Group	5,784,017	775,501	15%	112,933,442	19,040,526	20%	2,245,911	51	(2)	(4%)	19,786,764	87
Press	45,139	2,975	7%	-	-	-	-	-	-	-	-	-
Other (Mac, MES, Xenix, OS2)	112,840	51,202	83%	4,166,897	3,260,079	360%	351,215	27	(41)	(60%)	293,380	71
Gross Revenue	5,941,996	829,678	16%	117,100,339	22,300,605	24%	2,597,126	51	(3)	(6%)	20,080,144	87

* Line item includes both Standard and Upgrade revenue.

**Bundled CALs indicate client licenses bundled with server products. Not included in Rev/Lic calculation.

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BALANCE SHEET
(amounts in millions)

	Sep-96	Dec-96	Change
Assets			
Current assets			
Cash and short term investments	7,098	9,160	2,062
Accounts receivable	855	975	120
Other	279	307	28
Total current assets	8,232	10,442	2,210
Property, plant and equipment	1,304	1,322	18
Equity investments	896	804	(92)
Other assets	308	218	(90)
Total assets	10,740	12,786	2,046
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	887	848	(39)
Accrued compensation	196	289	93
Income taxes payable	514	480	(34)
Unearned revenues	651	1,013	362
Other	415	514	99
Total current liabilities	2,663	3,144	481
Minority interest	125	0	(125)
Put warrants	675	0	(675)
Stockholders' equity:			
Prefered stock and paid-in capital	0	980	980
Common stock and paid-in capital	3,220	3,541	321
Retained earnings	4,057	5,121	1,064
Total stockholders' equity	7,277	9,642	2,365
Total liabilities and stockholders' equity	10,740	12,786	2,046

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HEADCOUNT

	Sep-96	Dec-96			
	Actual	Actual	Plan	vs Sept 96	vs Plan
North America FG	1,700	1,729	1,929	29	(200)
Europe FG	1,781	1,827	1,943	46	(116)
Far East FG	492	520	565	28	(45)
ICON FG	810	870	967	60	(97)
Total FG	4,783	4,946	5,404	163	(458)
WW PSS	3,336	3,235	3,635	(101)	(400)
WW OEM	258	261	274	3	(13)
WW MCS	997	1,081	1,176	84	(95)
PNS	72	85	86	13	(1)
VP	56	65	82	9	(17)
Other	156	163	186	7	(23)
Sales, Marketing & Support Total	9,658	9,836	10,843	178	(1,007)
Platforms & Applications Group					
Desktop Applications	1,546	1,555	1,686	9	(131)
Desktop & Business Systems	2,142	2,241	2,334	99	(93)
Consumer Platforms	194	221	228	27	(7)
Internet Platform & Tools	1,848	1,845	1,955	(3)	(110)
Softimage	169	167	185	(2)	(18)
Group management	262	267	334	5	(67)
Total	6,161	6,296	6,722	135	(426)
Interactive Media Group					
Interactive Media	1,053	1,213	1,413	160	(200)
Hardware	109	117	119	8	(2)
Desktop Finance	114	125	134	11	(9)
Group management	183	195	227	12	(32)
Total Interactive Media Group	1,459	1,650	1,893	191	(243)
Interactive media investment	11	11	0	0	11
Press	76	79	87	3	(8)
Research & Development Total	7,707	8,036	8,702	329	(666)
General & Administrative					
Info Technology Group	537	525	560	(12)	(35)
HR/Admin Services	750	710	886	(40)	(176)
Executive Staff	8	8	8	0	0
Legal & Corporate Affairs	254	267	293	13	(26)
Finance	320	334	389	14	(55)
Payables & Procurement	87	85	87	(2)	(2)
Corporate Marketing	27	29	34	2	(5)
General & Administrative Total	1,983	1,958	2,257	(25)	(299)
Operations	1,189	1,162	1,373	(27)	(211)
GRAND TOTAL	20,537	20,992	23,175	455	(2,183)

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Q97-1 Board of Directors' Report

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This report was prepared with Word for Windows 7.0. All tables were created in Excel 7.0 and either embedded in the document or linked to master spreadsheets. Additionally, most of the channel and product group tables were generated via automation from the general ledger. Each of these automated tables is made accurate in its calculations by using data at a lower level than the rounded amounts shown in this report. These lower level amounts are used to calculate variances and are then rounded and displayed in this report. Therefore, individual amounts are rounded perfectly but totals and variances may not foot precisely. All other tables have individual numbers that may be rounded. While these individual numbers may not tie precisely to supporting schedules, they will foot exactly as shown in this report.

(NOTE: Revenue is "net" unless otherwise stated. Gross revenue is net of returns.)

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EXECUTIVE SUMMARY

MICROSOFT CORORATION INCOME STATEMENT

EXTERNAL GAAP RESULTS

(in millions, except earnings per share)	Q97-1		Q96-1		Growth	Q96-4		Growth
Net revenue	$2,295	100%	$2,016	100%	14%	$2,255	100%	2%
Operating expenses:								
Cost of revenue	250	11%	322	16%	(22%)	241	11%	4%
Research & development	432	19%	302	15%	43%	453	20%	(5%)
Sales & marketing	625	27%	621	31%	1%	661	29%	(5%)
General & administative	86	4%	63	3%	37%	90	4%	(4%)
Total operating expenses	1,393	61%	1,308	65%	6%	1,445	64%	(4%)
Operating income	902	39%	708	35%	27%	810	36%	11%
Interest income	92	4%	66	3%	39%	92	4%	-
Other expenses	(49)	0%	(4)	0%	nm	(42)	0%	17%
Income before income taxes	945	41%	770	38%	23%	860	38%	10%
Provision for income taxes	(331)	(14%)	(271)	(13%)	22%	(301)	####	10%
Net income	$614	27%	$499	25%	23%	$559	25%	10%
Earnings per share	$ 0.95		$ 0.78		22%	$ 0.87		9%
Weighted avg shares outstanding	647		640			645		

	Q97-1	Q96-4	Q96-3	Q96-2	Q96-1	Q95-4	Q95-3	Q95-2
Net revenue (in millions)	$2,295	$2,255	$2,205	$2,195	$2,016	$1,621	$1,587	$1,482
Operating inc. (% of net revenue)	39.3%	35.9%	35.1%	35.8%	35.1%	32.8%	34.6%	35.1%
Net income (% of net revenue)	26.8%	24.8%	25.5%	26.2%	-24.8%	22.7%	25.0%	25.2%
Earnings per share	$0.95	$0.87	$0.88	$0.90	$0.78	$0.58	$0.63	$0.60

Q97-1 Highlights

- Net revenue as reported externally was $2.30 billion, an increase of 14% over the comparative quarter in FY96 and 2% over the sequential quarter. Year over year growth was primarily driven by sales of Windows 95, Office and Office Pro, and Business System products, particularly Windows NT. Windows 95 with $558 million of gross revenue in Q97-1, was 32% over sell-thru revenue of $423 million in Q96-1. Unearned revenue related to operating systems and maintenance contracts totaled $651 million at September 30, 1996.
- Cost of revenue as a percent of net revenue declined to 10.9% from 16.0% in Q96-1. The overbuild of Desktop 95 product was fully absorbed into cost of revenue in Q96-1. Additionally, costs of revenue decreased due to increased corporate licensing and increased shipment of products on CD-ROM, which carry lower cost of goods than floppy disks.
- Research & development costs, representing 19% of net revenue, grew 43% over the prior year's quarter. R&D costs increased across all product divisions, (particularly in Desktop Applications, Interactive Media, and Desktop and Business Systems) and were primarily driven by headcount related costs and third party development.
- Other expenses include investments in MSNBC and DreamWorks JVs of $37 million.
- Net income for the quarter totaled $614 million, a 23% increase over Q96-1. Earnings per share increased 22% to $0.95.

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CONSOLIDATED MANAGEMENT P&L

INTERNAL MANAGEMENT RESULTS

($ in millions)	Q97-1 Actual		Budget		% of Bud
Gross revenue (as billed)	$2,529.6	102%	$2,212.4	103%	114%
Other revenue adjustments	(50.8)	(2%)	(70.4)	(3%)	72%
Net revenue	2,478.8	100%	2,141.9	100%	116%
Cost of revenue	259.2	10%	290.9	14%	89%
Gross profit	2,219.7	90%	1,851.0	86%	120%
Operating expenses:					
Product development:					
Applications & Content	160.0	6%	234.0	11%	68%
Platforms	202.4	8%	251.9	12%	80%
Interactive Media Invest.	37.4	2%	38.1	2%	98%
Product Marketing	50.7	2%	66.2	3%	77%
Other	7.9	0%	7.1	0%	113%
	458.5	18%	597.2	28%	77%
Sales & Marketing:					
Sales expense	238.7	10%	273.5	13%	87%
Marketing	101.5	4%	156.5	7%	65%
Broad Reach	23.2	1%	27.7	1%	84%
Product support	104.5	4%	120.9	6%	86%
	467.8	19%	578.6	27%	81%
General & administrative	60.4	2%	69.6	3%	87%
Total operating expenses	986.7	40%	1,245.4	58%	79%
Operating income	$1,232.9	50%	$605.7	28%	204%
Head Count	20,537		22,899		90%

	Q97-1	Q96-4	Q96-3	Q96-2	Q96-1	Q95-4	Q95-3	Q95-2
Cost of sales % of net revenue	10.5%	12.3%	13.2%	15.5%	15.1%	14.4%	14.8%	15.0%
Marketing expense % of net revenue	7.1%	13.4%	7.4%	11.4%	11.6%	9.0%	11.3%	13.0%
Product dev. expense % of net revenue	16.5%	17.8%	15.1%	13.7%	15.3%	16.3%	13.8%	13.5%
PSS expense % of net revenue	4.2%	5.0%	5.1%	6.0%	5.4%	6.4%	5.1%	5.1%
Average worldwide headcount	20,566	20,406	20,016	19,399	18,416	17,534	16,873	16,134

NOTES TO CONSOLIDATED MANAGEMENT REPORTS

The consolidated management P&L is based on functional responsibility and prepared in accordance with MAP (Microsoft Accounting Principles). These results include the impact of certain adjustments and reclassifications as required by Generally Accepted Accounting Principles (GAAP) for external reporting and exclude non-operating items and income taxes. Significant differences between financial statements prepared for internal management use and externally reported results include:

- Revenue for internal management reports is generally recognized "as billed." Under GAAP, net revenue includes adjustment for certain billed, but unearned revenue, such as a portion of operating system revenue that will be recognized over the product life cycle. Conversely, certain revenue that is earned but not yet billed, such as unreported OEM and Select revenue, is also recognized for external purposes.
- For external reporting purposes, the net cost of MSN operations is included as research and development expenses until such time as MSN has profitable gross margins. For internal management reporting, MSN revenue and cost of operations are shown grossed up as a business channel.
- For external reporting purposes, all product marketing related activities are classified as sales and marketing expense. For internal reporting purposes, product marketing departments and related marketing expenses are included in product development.

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REVENUE SUMMARY

Gross Product Revenue - Q97-1
(As shipped , in millions)

	Gross Revenue			Actual as % of		
	Actual	Plan	FY96*	Total	Plan	FY96*
Desktop Applications	$ 1,022.6	$ 996.4	$ 871.4	40%	103%	117%
Desktop Systems	862.0	653.9	735.0	34%	132%	117%
Business Systems	306.0	234.5	118.7	12%	130%	258%
Internet Platform and Tools	118.3	107.2	134.3	5%	110%	88%
Hardware	77.9	77.1	103.5	3%	101%	75%
Interactive Media	68.2	85.6	58.0	3%	80%	118%
All other products	74.6	57.7	82.5	3%	129%	90%
Gross revenue	$ 2,529.6	$ 2,212.4	$ 2,103.3	100%	114%	120%

* Adjusted for Desktop95 reserve

- Q97-1 gross revenue was $2.53 billion. 14% over plan and 20% ahead of FY96, which was adjusted for excess inventory of Desktop 95 products. Revenue growth over plan was driven primarily by Windows 95 (28% over plan) and Windows NT (Servers, Workstation & User licenses) which was $105 million or 75% over plan with the release of Version 4.0. Year over year growth, after adjusting for Desktop 95 reserves, was primarily driven by strong sales of Windows 95, Office and Office Pro, and BackOffice products, particularly Windows NT which increased more than 250% or $175 million.
- Desktop Applications Division gross revenue for the quarter totaled $1.02 billion, 3% over plan, driven primarily by Office and Office Pro which, combined, were 9% over plan. Revenue from 32-bit apps represented about 53% of total division revenues.
- Windows 95 and Windows NT Workstation revenues made up 77% of the total Desktop Systems revenues. Windows 95 revenues for the quarter were $558 million, 28% over plan. NT Workstation revenues for the quarter, with the release of Version 4.0, amounted to $110 million or 95% over plan.
- Revenues from Windows NT Servers (including user licenses) with $135 million for the quarter (62% over plan), drove most of the $71 million or 30% positive variance to plan in the Business Systems division.
- Q97-1 revenues from Interactive Media were 20% below plan primarily due to lower than planned MSN billings, offset by revenues from new gaming titles released in the quarter. MSN subscribers for the quarter approximated 1.4 million.

Gross Channel Revenue - FY96
(In millions)

	Gross Revenue			Actual as % of		
	Actual	Plan	FY96 *	Total	Plan	FY96*
North America FG	$ 859.3	$ 705.9	$ 742.4	34%	122%	116%
Europe FG	463.2	413.1	494.1	18%	112%	94%
ICON FG	158.7	161.6	151.9	6%	98%	104%
Far East FG	258.3	221.8	165.6	10%	116%	156%
Total finished goods	1,739.5	1,502.3	1,554.0	69%	116%	112%
OEM	744.6	641.7	520.9	29%	116%	143%
Other	45.5	68.3	28.5	2%	67%	160%
Net revenue	$ 2,529.6	$ 2,212.4	$ 2,103.3	100%	114%	120%

* Adjusted for Desktop95 reserve

- Gross finished goods (FG) revenue for the quarter totaled $1.74 billion, 16% over plan and growing 12% over FY96 after adjusting for Desktop 95 reserves. All regions, except ICON, finished above plan primarily due to higher than planned sales of Office and Office Pro, Windows 95 and Windows NT. ICON's below plan revenues were driven by lower than planned Office sales in Australia.
- All major sales locations were above plan for the quarter with the exception of France and Australia. France was 94% of plan mainly due to lower than planned sales of Desktop applications and systems. Reduced governmental purchasing and a slowdown after a strong Q96-4 caused Australia's lower than planned sales.
- Q97-1 OEM revenue exceeded plan by 16% with revenue of $745 million driven primarily by continued strong worldwide PC growth. Windows 95 is estimated to be installed in 74% of the PCs shipped worldwide.

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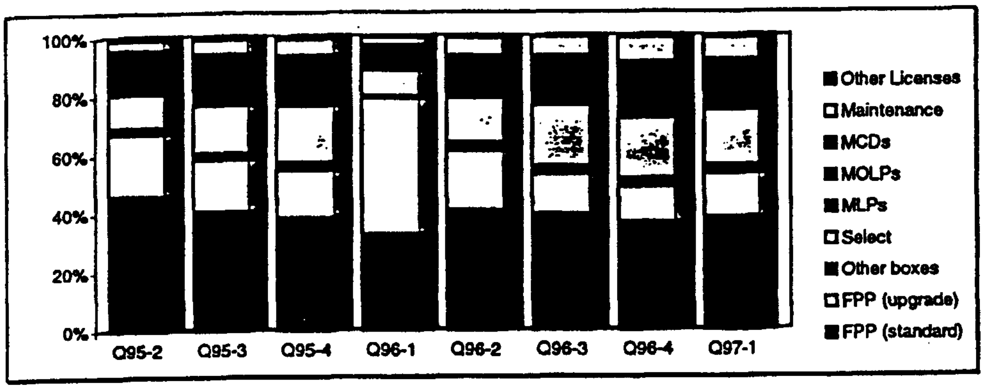
LICENSE MIX - FINISHED GOODS *(BASED ON REVENUE)*

Gross Shipments (excludes returns)



- Sales of full-packaged product (including upgrades) on a gross shipment basis was 56% of total finished goods revenue. The Q97-1 full-packaged product mix was higher than Q96-4 reflecting the successful sell-in of Windows NT 4.0. The Q96-1 abnormal increase in FPP reflects initial sell-in of Windows 95 and Office 95 into the retail channel.
- Revenue from Select licenses (including Select maintenance included in the "maintenance" category above) was $332 million in Q97-1, 2% over Q96-4, but grew 51% over the same quarter last year. Total License revenue for the quarter, before returns and adjustments, $785 million (44% of total FG revenue).

Foreign Exchange Impact on Consolidated Gross Revenue

(in millions)	Q97-1 Variance vs. Plan		
	Volume	FX	Total
North America FG	$153.4	$0.0	$153.4
Europe FG	34.6	15.5	50.1
ICON FG	(4.3)	1.2	(3.0)
Far East FG	18.4	18.1	36.5
OEM, Other AT & Channels	80.2	0.0	80.2
Variance to plan	$282.4	$34.9	$317.2

- The above table summarizes the impact of actual foreign exchange rates on gross revenues compared to plan for Q97-1. Actual exchange rates compared to plan resulted in a net positive FX variance of $35 million for the quarter on a gross revenue basis.
- The US dollar was weaker than planned against most major European currencies resulting in positive revenue variance of $16 million for the quarter.
- A weaker than planned dollar-to-yen exchange prevailed in Japan, resulting in a $18 million positive foreign exchange variance for the year in the Far East FG channel. During the quarter, the rate averaged 105.6 Yen per dollar compared to a budget rate of 115 Yen.

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COST OF REVENUE

Cost of Revenue - Q97-1	Sales Mix	Wghted Ave Cost	Cost of Revenue Actual	Cost of Revenue Plan
By Channel				
North America FG	33.3%	3.5%	10.6%	15.6%
Europe FG	18.2%	2.0%	10.8%	13.5%
ICON FG	6.3%	0.9%	15.1%	20.0%
Far East FG	10.1%	1.1%	10.7%	13.2%
Total Finished Goods	67.8%	7.5%	11.1%	15.1%
OEM	30.0%	1.0%	3.4%	4.3%
Other (includes MSN)	2.2%	1.9%	86.4%	68.2%
	100.0%	10.4%	10.4%	13.6%
By Product Division				
Desktop Apps	39.5%	2.9%	7.3%	9.6%
Desktop Finance	0.1%	0.1%	67.9%	45.4%
Hardware	3.0%	1.7%	55.4%	62.0%
Interactive Media	3.1%	2.3%	74.9%	63.4%
Applications & Content	45.7%	6.9%	15.2%	17.3%
Desktop & Business Systems	47.2%	2.2%	4.7%	6.8%
Consumer Platforms	0.0%	0.0%	-7.4%	nm
Internet Platforms&Tools	5.2%	1.0%	18.4%	26.4%
Softimage	0.3%	0.0%	6.0%	11.2%
Platforms	52.8%	3.2%	6.0%	8.8%
Other (primarily MS Press)	1.5%	0.3%	21.7%	45.0%
	100.0%	10.4%	10.4%	13.6%

- Q97-1 cost of revenue in the finished goods channel was 4 points better than plan due to a favorable mix of high margin products (Windows NT 4.0) and CD-ROM media (68% of total packaged product vs 61% planned) and lower than budgeted inventory charges.
- Q97-1 CD-ROM mix by division compared to plan is illustrated in the following table:

	Actual	Plan
Desktop Applications	56%	41%
Desktop & Business Systems	62%	55%
Interactive Media (software)	87%	86%
Internet Platform & Tools	89%	88%
Desktop Finance	59%	72%
Total	68%	61%

- Cost of revenue in the OEM channel was 0.9 percentage points less than plan mainly due to the higher mix of revenue from software licensed products versus hardware.
- Cost of revenue across all product divisions, with the exception of Desktop Finance and Interactive Media, was below plan primarily due to the shift to license sales and CD-ROM media. Interactive Media includes the costs of MSN which are higher than plan primarily due to higher Internet related (access, service and connection) costs.

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OPERATING EXPENSES
(in millions)

	Q97-1	Plan	% of Plan
People costs	$437.2	$494.4	88%
Contingent staff and outsourcing	132.6	150.1	88%
Infrastructure costs	143.0	164.6	87%
Marketing expenses	177.5	254.6	70%
PSS/MCS cost recovery	(69.7)	(70.7)	99%
Third party product development	62.7	125.1	50%
Other expenses	103.3	127.3	81%
	$986.7	$1,245.4	79%
Avg non-operations headcount	19,107	20,740	92%
People cost per head	$91,525	$95,351	96%
Infrastructure cost per head (annualized cost per average MS head)	$29,939	$31,736	94%
Contingent staff and outsourcing (as a percentage of People costs)	30.3%	30.4%	

(Note: excludes heads and expenses related to Operations included in Cost of Revenue)

- Operating expenses were at $987 million, 21% below plan for the quarter primarily due to lower than planned headcount levels, slower than planned implementation of marketing programs and reduced spending on third party development.

- On a cost per head basis, People costs were below budget due to reduced Travel, Recruiting and Supplies spending. Payroll expenses approximated plan on a cost per head basis.

- Contingent staff was below or at plan across all groups, except Microsoft Consulting Services (MCS) which was $3 million (43%) over plan. Increased use of subcontractors at MCS was offset by higher than planned (30%) subcontractor revenue.

- Infrastructure costs for Q97-1 totaled $143 million, 13% below plan and 6% below plan on a cost per head basis. The main drivers of the cost per head variance are depreciation expense (primarily PC related) and telecommunication expense which were 11% and 10% below plan, respectively.

- Marketing expenses were $77 million (30%) below budget as all regions were slower than planned in implementing their marketing programs. Total marketing expenses were 17% of full year budget.

- PSS/MCS cost recovery was about even with budget as higher MCS revenue (4% above plan) were offset by lower than planned Premier support contract revenue.

- Reduced usage of external development resources and a shift of localization spending to the later quarters (due to product ship schedule changes) resulted in third party development spending being $62 million (50%) below plan. All divisions, particularly DAD and IMD, were below plan.

- Other expenses which include bad debt, taxes & licenses and miscellaneous operating expenses, were $24 million (19%) below plan primarily due to unused discretionary marketing budget ($11 million) for Internet platforms and tools and lower than planned professional fees ($10 million).

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PRODUCT GROUP COSTS
(in millions)

	Q97-1				
	Actual		Plan		% of Plan
Platform Product Group					
Desktop & Business Systems	$87.4	19%	$101.6	17%	86%
Consumer Platforms	14.9	3%	17.6	3%	85%
Internet Platforms & Tools	81.4	18%	106.3	18%	77%
Softimage	6.7	1%	7.7	1%	87%
Platform Mgmt	10.5	2%	17.0	3%	62%
Total Platform Products	200.9	44%	250.1	42%	80%
Application Content Group					
Desktop Applications	$57.7	13%	$80.2	13%	72%
Desktop Finance	4.1	1%	6.7	1%	61%
Hardware	10.9	2%	11.8	2%	93%
Interactive Media	79.5	17%	123.8	21%	64%
Research & mgmt	8.1	2%	10.5	2%	77%
Total Application & Content	160.4	35%	233.0	39%	69%
Product Marketing	50.7	11%	66.2	11%	77%
Interactive Media Investments	37.4	8%	38.1	6%	98%
Other	8.5	2%	9.8	2%	87%
Total	$457.9	100%	$597.2	100%	77%

- Product group costs totaled $458 million for the quarter, $139 million (23%) below plan due to lower than plan headcount across all divisions, below plan product marketing and third party development spending.
- Platform Product Group average headcount was about 3% below plan and Application and Content Group average headcount was about 8% below plan.
- Third party development spending was $18 million (42%) below plan in Platform Group and $42 million (56%) below plan in the Applications and Content Group. Planned spending levels are expected to be reached as we get closer to the Office 97 RTM and localization schedules.
- Interactive Media investment costs for the quarter of $37 million included $25 million for MSNBC Cable Joint Venture, $9 million for MSNBC Interactive Joint Venture and $3 million for DreamWorks Interactive.

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SALES, MARKETING & SUPPORT COSTS
(in millions)

	Q97-1				
	Actual		Plan		% of Plan
Sales Expenses					
North America	$71.1	15%	$82.5	14%	86%
Europe	57.0	12%	66.6	12%	86%
ICON	24.2	5%	29.8	5%	81%
Far East	19.1	4%	20.5	4%	93%
OEM	25.9	6%	25.4	4%	102%
Other	41.8	9%	48.7	8%	86%
Total sales expenses	239.2	51%	273.5	47%	87%
Marketing Costs	124.7	27%	184.2	32%	68%
Support Cost	104.5	22%	120.9	21%	86%
Total	$468.4	100%	$578.6	100%	81%

- Q97-1 sales expenses totaled $239 million. 87% of plan primarily due to lower than plan headcount. Expense in the OEM channel was 2% over budget due to additional taxes, licenses and bad debt expenses which are a function of revenue. OEM revenue was 16% over plan.
- Channel marketing, including Broad Reach, totaled $125 million for the quarter, 32% below plan primarily due to slower implementation of marketing programs than budgeted.
- Product support costs were 14% below with plan for the quarter due to lower staffing costs. Average worldwide PSS headcount was about 8% below plan in the quarter. Support costs were 4.2% of net revenue for the quarter, compared to a budget of 5.6%.

GENERAL & ADMINISTRATIVE COSTS
(in millions)

	Q97-1				
	Actual		Plan		% of Plan
Admin Services	$77.2	49%	$93.2	48%	83%
ITG	44.0	28%	54.7	28%	80%
Legal	19.1	12%	25.8	13%	74%
Finance	15.2	10%	20.4	10%	74%
Other	3.2	2%	1.9	1%	168%
Gross G&A spending	158.7	100%	196.0	100%	81%
Distribution	(98.2)		(126.5)		
Total	$60.4		$69.6		

- General and administrative costs include corporate cost centers that support MS on a worldwide basis. Net expenses, after distributions, include IT project development and regional support, corporate finance, legal and corporate affairs, HR services such as employee development, compensation and recruiting, and certain worldwide real estate and administrative support services. Distributed costs included employee benefits, IT support, real estate expenses and services such as the copy center and company store.
- For the quarter, gross general and administrative costs were 19% below plan due to lower than plan headcount across all groups. Net G&A costs were at $60 million or 2.4% of net revenue compared to a plan of 3.2% of net revenue.

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CASH FLOW SUMMARY

	Q96-4	Q97-1	Change
Beginning cash & equivalents	$2,937	$2,601	($336)
Cash flow from operations			
Net income	559	614	55
Depreciation	143	162	19
Current liabilities	134	227	93
Accounts receivable	77	(205)	(282)
Other current assets	(7)	(15)	(8)
Net cash from operations	906	783	(123)
Cash flow from financing			
Common stock issued	120	215	95
Common stock repurchased	(461)	(697)	(236)
Stock option income tax benefits	109	106	(3)
Net cash from financing	(232)	(376)	(144)
Cash flow from investments			
Additions to property, plant and equipment	(152)	(99)	53
Equity investments and other	(367)	(156)	211
Short-term investments	(506)	259	765
Net cash used for investments	(1,025)	4	1,029
Net change in cash and equivalents	(351)	411	762
Effect of exchange rates on cash and equivalents	15	6	(9)
Ending balance of cash and equivalents	2,601	3,018	417
Ending balance of short term investments	4,339	4,080	(259)
Ending cash & short term investments	$6,940	$7,098	$158

- Cash and short term investments for the first quarter were $7.10 billion, $158 million (2%) higher than Q96-4 and $2.03 billion (40%) greater than a year ago.
- Cash from operations decreased by $123 million from the prior quarter primarily due to increased accounts receivable. Accounts receivable increased by $205 million reflecting channel sell-in of Windows 95 and Windows NT.
- The increased level of the stock buyback program was the primary driver of reduced cash from financing activities by $144 million compared to the prior quarter. 5.7 million shares were repurchased at an average cost of $125.73.
- As the duration of the portfolio was reduced, investments classified as cash & equivalents increased and securities classified as short term investments decreased.

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Operations

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OPERATIONAL HIGHLIGHTS Q97-1

EXECUTIVE SUMMARY

- During the quarter, Operations continued to execute key strategies of moving toward a turnkey manufacturing model, improving the product design and release processes, and improving end-to-end Licensing and Program Operations.

PACKAGED PRODUCT MANUFACTURING TRANSITION

- The sale of the Canyon Park (CP) manufacturing operation to Kao Infosystems was completed during the quarter. CP/Kao transitional issues, coupled with high unit volumes, resulted in some production shortfalls which negatively impacted lead times and fill rates during the quarter.
- At MS Puerto Rico, CD replication came on-line as scheduled in July and is now meeting its volume targets of 1.25 million CDs per month.
- Starpack is now fully functioning as the North American turnkey manufacturer of Interactive Media packaged products, resulting in lower costs and quicker time to market.

PRODUCT DESIGN AND RELEASE

- During the quarter, Operations restructured the product design and release groups to align better with the product groups. Focus on improved artwork delivery process and art quality resulted in on time release of new Interactive Media titles including International English versions.
- A new, ongoing standardized process of product design, combined with the manufacturing transition to Starpack and improved inventory planning processes, resulted in an estimated total savings of $8.6 million.

LICENSING OPERATIONS

- Select/Retail Licensing Operations made significant progress in delivering required process infrastructure with the implementation of the MS Product system to support Select pricing and enhancing MS Sales to support Select revenue visibility.
- Selectronic, a secure Internet-based application, was introduced to provide access to Select program information for North American Large Account Resellers (LAR's).
- During the quarter, OEM Operations implemented the OEM License Wizard. This application facilitates the creation of license agreements by utilizing worldwide standards resulting in a decrease of approximately 30% in the time required for the OEM to be functioning under the agreement.

PROGRAM OPERATIONS

- Internet-based solutions were deployed for the Beta CD subscription program and order processing for direct fulfillment programs. The Beta CD Intranet application was successfully extended to support European and Latin American customers. An outsourced direct fulfillment order processing solution was deployed in support of Visual J++ (VJ++) and Money 97 upgrade promotions. After the first 30 days, 75% of VJ++ orders and 25% of Money 97 upgrades placed were done via the Internet. This capability will be extended to other programs in the second quarter.

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COST OF REVENUE BY REGION

Q97-1 FINISHED GOODS GROSS MARGIN ANALYSIS

(In Millions)

	North America				Europe				Far East				ICON				Total Finished Goods			
	Actual		Plan		Actual		Plan		Actual		Plan		Actual		Plan		Actual		Plan	
Net Revenue	826.1	100.0%	668.5	100.0%	450.9	100.0%	398.3	100.0%	250.6	100.0%	212.0	100.0%	155.1	100.0%	154.9	100.0%	1,682.7	100.0%	1,433.7	100.0%
Costs of Revenue:																				
Product Costs	49.6	6.0%	59.5	8.9%	24.3	5.4%	25.2	6.3%	18.1	7.2%	17.7	8.3%	14.0	9.0%	16.5	10.7%	106.0	6.3%	118.9	8.3%
Royalties	11.4	1.4%	8.2	1.2%	4.8	1.1%	4.7	1.2%	3.0	1.2%	3.2	1.5%	1.9	1.2%	1.7	1.1%	21.1	1.3%	17.8	1.2%
Pipe Costs	10.7	1.3%	13.3	2.0%	8.5	1.9%	9.8	2.5%	1.4	0.6%	1.7	0.8%	4.7	3.0%	6.4	4.1%	25.3	1.5%	31.2	2.2%
Obsolete & Scrapped Inventory	9.2	1.1%	14.2	2.1%	3.8	0.8%	5.8	1.5%	1.8	0.7%	2.5	1.2%	2.0	1.3%	4.6	3.0%	16.8	1.0%	27.1	1.9%
Channel Costs	6.5	0.8%	9.0	1.3%	7.4	1.6%	8.3	2.1%	2.5	1.0%	2.9	1.4%	0.8	0.5%	1.8	1.2%	17.2	1.0%	22.0	1.5%
Total Cost of Revenue	87.4	10.6%	104.2	15.6%	48.8	10.8%	53.8	13.5%	26.8	10.7%	28.0	13.2%	23.4	15.1%	31.0	20.0%	186.4	11.1%	217.0	15.1%
Gross Margin	738.7	89.4%	564.3	84.4%	402.1	89.2%	344.5	86.5%	223.8	89.3%	184.0	86.8%	131.7	84.9%	123.9	80.0%	1,496.3	88.9%	1,216.7	84.9%
License Mix																				
Full Packaged Product	48.6%		57.8%		36.7%		51.0%		54.0%		61.7%		45.7%		52.2%		46.3%		56.3%	
CD-ROM Mix, by Division																				
Desktop Applications	50%		32%		34%		30%		90%		81%		39%		26%		56%		41%	
Desktop & Business Systems	61%		54%		66%		58%		69%		71%		49%		33%		62%		55%	
Interactive Media	88%		89%		87%		81%		66%		74%		91%		85%		87%		86%	
Internet Platforms & Tools	89%		92%		83%		86%		96%		90%		72%		57%		89%		88%	
Desktop Finance	66%		58%		n/m		86%		80%		45%		66%		46%		59%		72%	
Total	66%		59%		60%		59%		86%		82%		62%		45%		68%		61%	

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FINISHED GOODS COST OF REVENUE SUMMARY

- Total cost of revenues for Q97-1 were lower than budget by $31 million or 4% of net revenue due to lower total product costs, pipe costs and obsolete and scrapped Inventory. The following table summarizes the total variance to budget.

Line Item	Variance Amount $	% of Net Rev
Product Costs	13	2.0
Royalties	(3)	(0.1)
Pipe costs	6	0.7
Obsolete & scrap Inventory	10	0.9
Channel Costs	5	0.5
Total variance	31	4.0

- Product costs were below budget by 2 points as a percent of net revenue primarily due to the increased mix of licensed product and CD-ROM media. Licenses for Select and MOLP, as a percent of total finished goods, was at 54% for the quarter compared to a budget mix of 44% (based on units, not revenue). CD ROM media, was 68% of the packaged product revenue in the quarter compared to a budgeted level of 61%.
- Royalties were above budget primarily due to increased third party royalties due to higher than budgeted subscriptions for MSDN Universal, sales of SQL Server and several Interactive Media division titles.
- Total pipe costs were less than budget by $6 million or 0.7 points of net revenue due to below budget headcount.
- Total obsolete and scrapped inventory costs were better than budget by $10 million (0.9 points of net revenue) due to lower than anticipated obsolescence charges.
- Total channel costs were less than budget by $5 million (0.5% of net revenue) primarily due to lower than expected fulfillment activities for MSDN, MES Courseware, supplemental parts and other programs.

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COST OF REVENUE BY BUSINESS STREAM

Q97-1 FINISHED GOODS AND OEM GROSS MARGIN ANALYSIS

(In Millions)

	Channel FPP		Licensing		Programs		Total FG
	Software	Hardware	OEM	Retail	Subscriptions	Fulfillment	& OEM
Actual							
Net Revenue	$898.8	$75.5	$709.5	$654.5	$52.3	$35.6	$2,426.2
Cost of Revenue							
Product Costs	66.8	38.4	0.0	4.7	6.2	8.0	124.1
Royalties	12.4	0.4	3.8	5.7	2.4	0.2	24.9
Pipe Costs	13.2	3.4	1.7	5.2	1.8	2.7	28.0
Obsolete & Scrapped Inventory	16.0	0.1	0.0	0.0	0.0	1.0	17.1
Channel Costs	4.7	0.8	0.1	0.3	3.1	8.1	17.1
Total Cost of Revenue	113.1	43.1	5.6	15.9	13.5	20.0	211.2
Gross Margin	$785.7	$32.4	$703.9	$638.6	$38.8	$15.6	$2,215.0
Cost of Revenue %	12.6%	57.1%	0.8%	2.4%	25.8%	56.2%	8.7%
Variance from Budget - Fav (Unfav)							
Net Revenue	$126.6	$1.8	$100.5	$123.7	$22.0	($22.3)	$352.3
Cost of Revenue							
Product Costs	6.4	4.3	0.0	(3.5)	(2.3)	8.1	13.0
Royalties	(1.1)	(0.1)	(0.7)	(1.1)	(1.0)	0.0	(4.0)
Pipe Costs	3.3	0.7	1.3	1.2	0.4	0.6	7.5
Obsolete & Scrapped Inventory	8.3	2.8	0.0	0.0	0.0	0.4	11.5
Channel Costs	1.0	0.0	0.0	0.0	1.3	2.8	5.1
Total Cost of Revenue	17.9	7.7	0.6	(3.4)	(1.6)	11.9	33.1
Gross Margin	$144.5	$9.5	$101.1	$120.3	$20.4	($10.4)	$385.4
Cost of Revenue %	4.4%	11.7%	0.2%	-0.1%	13.5%	-1.0%	3.1%

BUSINESS STREAM COST OF REVENUE SUMMARY

- During FY96, Worldwide Operations began reporting COGS by business stream, a view that is more consistent with MS's changing business model as illustrated by the dramatic shift from manufacturing packaged product to license and subscription programs. Beginning in FY97, reporting by business stream is being incorporated into the routine monthly and quarterly reporting cycle.
- Channel package product cost of revenues were lower than the budget by $18 million or 4.4% of net revenue. This favorable variance resulted from below budget manufacturing spending in manufacturing, pipe operations and obsolete and scrapped inventory.
- Hardware cost of revenues were under budget by $8 million or 12% of net hardware revenue due to below budget product and inventory costs. Product costs were favorable to budget due to a lower mix of keyboard and gaming device sales. Obsolete and scrapped inventory costs were lower than budget due to reduced obsolescence accruals.
- Retail Licensing costs of revenues exceeded budget by $3 million primarily due to higher than budgeted volume license sales of $124 million. Product costs were higher than budget by $4 million due to higher than planned demand for disk and document sets in support of licensing.
- Subscription costs were $2 million higher than budget due to increased MSDN sales resulting in additional product costs and royalties. Direct fulfillment product and channel costs were below budget due to lower than anticipated activity.

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KEY PERFORMANCE METRICS

Distributed Operations (Channel Packaged Product)

	North America		Europe		Far East *		ICON		Total Channel FPP	
	Q97-1 Actual	FY97 Goal	Q97-1	FY97 Goal	Q97-1	FY97 Goal	Q97-1	FY97 Goal	Q97-1	FY97 Goal
Lead Time (days)	7	7	12	10	24	14	17	15	12	10
Fill Rate % **	81.0%	95.0%	83.0%	80.0%	37.0%	65.0%	57.0%	65.0%	78.7%	81.0%
Inventory Turns	2.5	12.0	3.3	8.0	2.8	6.5	3.4	8.0	2.7	9.5
$ Obsolete & Scrapped Inventory	$9.2	$9.1	$3.8	$3.9	$0.2	$0.2	$2.0	$2.3	$15.2	$15.5
% of Net Revenues	1.1%	1.1%	0.8%	0.9%	1.2%	1.1%	1.3%	1.2%	1.1%	0.4%

* English & PRC product only

** Fill rate metric for Europe, ICON and Far East regions is based on an order receipt to ship time of 10 days. North America metric is based on 5 days.

- Actual Fill rates and Lead times were unfavorable by 4.3% and 2 days respectively. North America, ICON and Far East fill rates were lower than goal due to the transition of the Canyon Park Manufacturing to Kao. Far East was also negatively impacted by artwork delays, the transition from Canyon Park to Stream in Singapore. and delays in CD deliveries. Europe's lead time was over the goal due to production delays of Windows NT and Backoffice where were re-released after initial RTM.
- Inventory turns continue to be negatively impacted by excess Desktop 95 and Hardware inventory. Each region will experience improved turns as this inventory is reworked or scrapped.

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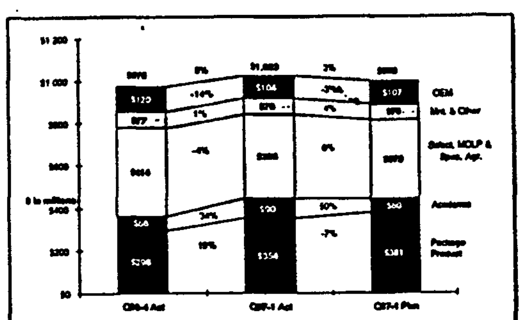
APPLICATIONS & CONTENT

Q97-1 P&L SUMMARY

($ in millions)	Desktop Apps		Interactive Media		Hardware		Desktop Finance		Mgmt Research		Total Group	
	Actual	Plan Var %	Actual	Plan Var %	Actual	Plan Var %	Actual	Plan Var %	Actual	Plan Var %	Actual	Plan Var %
Net Revenue	$979.1	3.1%	$76.7	(9.9%)	$75.8	3.7%	$2.5	(18.1%)	$0.0	-	$1,133.9	2.1%
Cost of Revenue	71.3	22.0%	57.4	(6.5%)	41.8	7.4%	1.7	(23.5%)	0.0	-	172.3	10.2%
Gross Margin	907.8	5.8%	19.3	(38.2%)	33.8	21.7%	0.8	(52.7%)	0.0	-	961.6	4.7%
% of Net Revenue	*93%*		*25%*		*45%*		*32%*		*nm*		*85%*	
Operating Expenses												
People	34.1	9.3%	28.2	30.2%	3.3	(7.3%)	2.7	15.7%	5.7	15.2%	74.1	18.7%
Infrastructure	11.0	21.1%	11.8	24.7%	1.3	18.2%	0.6	34.3%	1.4	28.4%	28.1	23.2%
Contingency Staff	5.2	31.3%	15.5	3.7%	2.5	(10.8%)	0.3	37.1%	0.4	67.9%	23.8	13.4%
Product Development	7.3	65.2%	23.2	53.6%	3.1	35.2%	0.6	71.5%	0.4	41.6%	34.8	55.9%
Domestic Product Marketing	14.0	15.1%	9.9	39.6%	0.3	74.9%	0.6	57.9%	0.0	81.3%	24.8	30.4%
Other	0.1	2.6%	0.8	49.8%	0.7	-	0.0	99.6%	0.3	(270.4%)	1.6	6.6%
Direct Controllable Operating Expense	71.7	25.9%	89.4	36.2%	11.2	14.1%	4.8	42.2%	8.1	23.0%	185.2	31.1%
Channel/International Marketing	49.1	27.0%	7.3	41.0%	2.2	42.7%	0.3	52.9%	0.0	-	58.9	30.0%
Product Support Services	30.9	25.5%	20.1	(24.3%)	0.4	36.7%	0.6	(61.4%)	0.0	-	52.0	12.3%
Tax, Insurance & Settlement	4.2	(11.3%)	0.7	(50.6%)	0.7	(3.3%)	0.0	5.3%	0.0	-	5.6	(13.8%)
Bad Debt Expense	6.7	2.7%	2.2	3.4%	0.4	21.6%	0.0	(27.3%)	0.0	-	9.4	3.8%
R&D Shared Resources	11.7	31.8%	3.7	(48.2%)	0.6	28.2%	0.3	28.7%	(7.6)	28.0%	8.8	34.6%
Total Operating Expenses	174.3	25.4%	123.4	29.0%	15.6	20.6%	6.0	38.3%	0.6	-	319.8	27.3%
Responsibility Margin	733.5	18.0%	(104.1)	27.0%	18.2	(123.1%)	(5.2)	35.3%	(0.6)	-	641.8	34.1%
% of Net Revenue	*75%*		*(136%)*		*24%*		*(208%)*		*nm*		*57%*	
Corporate Allocations	115.8	19.3%	27.7	19.2%	7.3	23.0%	2.6	16.5%	0.0	35.8%	153.4	19.4%
Contribution Margin	$617.7	29.2%	($131.9)	25.5%	$10.9	932.7%	($7.8)	30.1%	($0.6)	(440.8%)	$488.3	68.4%
% of Net Revenue	*63%*		*(172%)*		*14%*		*(308%)*		*nm*		*43%*	
Average Headcount	1,542	7.7%	1,024	8.2%	107	10.1%	104	12.6%	179	8.7%	2,958	8.2%
People cost per head	88,399	1.8%	110,168	24.0%	124,037	(19.3%)	104,615	3.5%	128,179	7.2%	100,210	11.4%
Infrastructure cost per head	28,578	14.5%	46,270	17.9%	49,009	9.0%	22,500	24.8%	30,972	19.4%	35,378	18.3%

BUSINESS RESULTS

- Net revenue for the Applications and Content Group (ACG) totaled $1.13 billion in Q97-1, $23 million (2%) better than plan and 18% better than last year. Continued growth in Office products combined with year over year growth in consumer software and MSN revenues were the major growth factors over Q96-1.
- Desktop Applications Division (DAD) Q97-1 net revenue of $979 million exceeded plan by $29 million, or 3%. This is slightly below the average quarterly revenue run rate for FY96 ($990 million) and is thought to be the beginning of a slow-down as channel and corporate customers prepare for the sell-in of Office 97.



DAD REVENUE MIX

- Interactive Media Division net revenue of $77 million was $8 million less than planned as conservative MSN subscription revenue estimates were accrued in light of continued billing system problems. Sales from the traditional consumer software product line beat plan by 6% as retail sell-in exceeded budget by 17% due to earlier than expected initial shipments into the channel of the new lineup of entertainment titles.
- Hardware division net revenue of $76 million exceeded plan by 4%. Strong retail sales of Mouse more than offset the delayed release of the IntelliMouse and a slowdown in retail sales of Sidewinder joysticks. Net revenue for Desktop Finance was 18% below plan, reflecting high returns in anticipation of the Money 97 launch in September.
- Gross margin for ACG was 2 percentage points better than plan and 4 percentage points better than Q96-4, reflecting the continuing favorable mix shift from package product to license sales, and, within the package product category, from disks to CD media.
- DAD Q97-1 gross margin was nearly 93%, 2 percentage points above plan and 3 points above the FY96 average. The primary drivers include mix increases in CD media and licensed products, and

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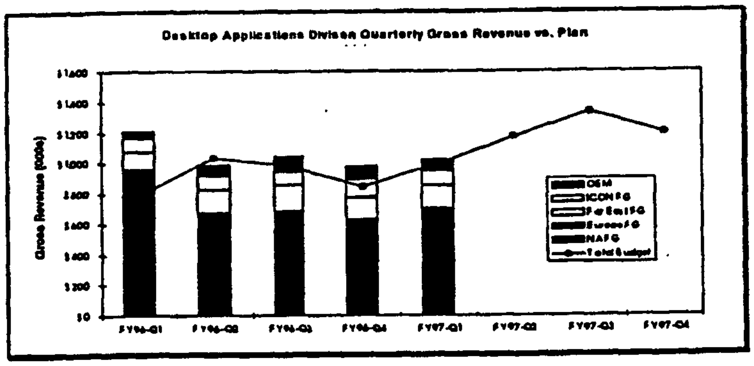
lower bill-of-material costs on floppy media product.

- DAD's Q97-1 operating expenses were 26% below plan. September headcount was 108 heads below plan (6%), leading to generally below-plan expenditures for most people and infrastructure related costs. Product development expenditures lagged plan primarily due to the slip in Office 97 RTM and delays in localization. Marketing expenditures were also below plan, but are expected to catch up next quarter. Also, incremental funding of marketing expenditures is likely in the next quarter to respond to Corel's success in the retail channel.
- Interactive Media Division direct operating expenses for the quarter trailed plan by $50 million or 36%. The variance was due primarily to below plan external product development spending for MSN programming. Direct expenses were also impacted by slower than planned headcount ramp and corresponding lags in recruiting and depreciation. Interactive Media regular headcount grew by 144 since the end of the prior quarter to end Q97-1 at 1,176. Headcount growth during FY97 will be focused on MSN, Sidewalk (Cityscape), and other on-line investment areas. In addition, the division currently employs 1,223 on-site contingent staff, a decrease of 38 since the beginning of the quarter.

OUTLOOK



- Due to the clearing of sales channels in anticipation of Office 97, achieving DAD Q2 budgeted revenue is a going to be a challenge. As shown by the graph above, the FY97 budget assumes a significant uptick in Q2 and Q3 revenue. Q96-1 gross revenues also included the large FPP sell-in of Office 95.
- Revenue from Interactive Media products is expected to be in line with expectations. The division expects to ship several new titles next quarter, including Flight Simulator for Windows 95, Golf 3.0, Soccer, Automap Trip Planner, and Nickelodeon 3D Movie Maker.
- MSN Subscription revenues is expected to increase. Total MSN membership now totals 1.6 million including 1.4 million paying subscribers and 200,000 trial members. MSN 2.0 (code-named Hartford) was announced in early October and on October 10th, MS hosted 120 editors and analysts for a Redmond event titled "The Microsoft Network Moves to the Web: Strategy for the Next Mass Medium." A second press event was held in New York on October 16th. At that event, MS unveiled a consumer advertising campaign, which included outdoor and print advertising, and television advertising that would commence in early November. This will be backed by heavy, targeted direct mail, show-specific publicity efforts, and aggressive consumer promotions.
- Hardware Division is expected to post strong results as the new IntelliMouse is released to the channel along with a seasonal uptick from sell-in of retail Sidewinder joysticks and Natural Keyboards.

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DESKTOP APPLICATIONS REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

Microsoft Office 97

- A detailed launch plan for Office 97 is now being finalized. The plan includes events, PR, roadshows, advertising, and a new 'trial CD', that demonstrates new features and the Office 97 interface, which will be sent to 2 million users. In addition to other promotions, a 'time bomb' version of OfficePro will be available through OEMs. This version will allow customers to use Office 97 for 60 days until the product disables itself.
- The initial response from trade publications on Office 97 has been very positive. Infoworld Office 97 review "The transformation of MS's best-selling suite has so many worthwhile improvements, its attraction to Office 95 users could prove irresistible". Computer Reseller News Online review: "Office 97 Fulfills Promise" "With hundreds of new features and shared logic that is common to all applications, this product exhibits a level of consistency across its constituent applications that has not been seen before".
- In addition to Office 97, several other new Office product bundles designed to appeal to small business and home users will be introduced.
- The Office Small Business Edition bundle (Word, Excel, Outlook, Publisher, Internet Explorer, MSN time, Automap Streets and Small Business Financial Manager) will be priced comparable to Office Standard and will replace OfficePro as the primary version of Office shipped through OEM.
- 'Home Essentials' (Word, Works, Encarta, Greetings Workshop, Internet Explorer, Arcade/Zones and MSN time) was introduced in the quarter. This is an upgrade SKU only and is priced at $99. The Home Essentials brand name will also be used around the world, although the product set may vary some by country.
- Publisher 97 is shipping into the finished goods channel. Demand has been incredibly strong with over 100,000 units of product on backorder. Sell-through to end users in the U.S. retail channel had surpassed 31,000 units after 6 weeks of sales
- The first major upgrade to FrontPage, Version 2.0, is currently in beta. There have been over 270,000 downloads from the FrontPage web site in the first three weeks of its availability. The production version is planned to RTM in mid November. Sales of Version 1.1 have exceeded expectations. At $12.9 million in Q97-1 net revenue, Vermeer Product Unit is already at 58% of total year's budget.

COMPETITION

Corel

- Corel launched Corel Office Professional 7, a 32-bit suite for Windows 95 that includes WordPerfect, Quattro Pro, Paradox, Presentations, CorelDRAW, CorelFLOW, Sidekick, Time Line, Netscape Navigator, Dashboard, GroupWise, InfoCentral, 1,000 Fonts and 10,000 Clipart Images. New users can buy this product for $439. Users can upgrade from any previous version of any of the named applications in the suite for $200.
- Street prices for Corel Office Suite upgrades have been seen as low as $79. The low-priced upgrade has sold very well in the US retail finished goods channel with unit market share as high as 50%. US retail sell-through of Corel Office is estimated to be approximately 70K units per month.
- Corel entered into a new licensing agreement with Sun in July for Java source code. Corel plans to use it in WordPerfect, CorelDraw, and Ventura products.

Lotus (IBM)

- It's expected that Lotus will finally ship its complete 32-bit SmartSuite in the January timeframe, concurrent with Office 97.
- Lotus continues to bundle SmartSuite 96 with hardware OEMs.
  - Lotus announced with Cyrix Corporation that customers purchasing certain Cyrix PCs will

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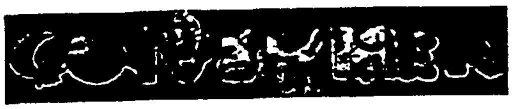
receive a complimentary Lotus SmartSuite 96 CD, as well as a CompuServe CD with trial membership.

- Agreement was also reached with Acer America Corporation to preinstall SmartSuite 96.
- IBM's own Aptiva line also carry SmartSuite96.

- Lotus announced that it has begun shipping Lotus Components, a set of software applets (ActiveX controls) for Lotus Notes. The company also announced plans to deliver a new release of Lotus Components for interactive Internet applications in 1997.

INTERACTIVE MEDIA REVIEW



INVESTMENTS & PRODUCT HIGHLIGHTS

- MSN's billing system is catching up on past due bills, as was stated in a letter that went out to all MSN members. Churn will potentially increase since customers are seeing two months worth of bills hitting their credit cards. International membership, currently at about 450,000, continues to exceed projections, especially in the UK and Japan.
- Microsoft's on-line city guide to entertainment (code-named Cityscape) recently chose and trademarked the name 'Sidewalk'. Although hiring of the local city teams has been slower than expected, a total of nine city GMs have been hired for Seattle, New York, Minneapolis, San Francisco, San Diego, Denver, Washington D.C., Sydney and Montreal. Seattle will release in Q97-3 release and New York, San Francisco and Boston are on track for Q97-4.
- In July, American Express signed a corporate travel licensing agreement with MS Expedia for an initial $10 million license fee to be followed by transaction fees based on transactions booked through the website. This licensing agreement allows American Express to use versions of MS Expedia for corporate and leisure travel reservations. The MS Expedia site, http://expedia.msn.com, went live on the web on October 22nd.
- Slate, Microsoft's interactive magazine of politics, culture and public policy, debuted in late June. Early tracking has been rudimentary, but Slate's audience appears to visit the site frequently rather than 'surf' through occasionally. Slate began compiling a list of people that receive weekly announcements or delivery of the magazine. Volume has grown steadily and is around 30,000 names as of the end of September. Jacob Weisberg, prominent columnist formerly of New York Magazine and The New Republic, was hired as Chief Political Columnist to cover the elections and ongoing political topics for Slate.
- Entertainment, Kids and the Information business units shipped several titles during Q97-1 in preparation for this holiday season. Key titles shipped include Deadly Tide, Hellbender, Monster Truck Madness, NBA Full Court Press, Nickelodeon 3D Movie Maker, PJ's Reading Adventure, Encarta Deluxe, Encarta World Atlas, Automap, Steets Plus, Cinemania 97 and Music Central 97. In addition, the first non-English versions (German) of Encarta encyclopedia and Encarta World Atlas were released to manufacturing.
- Microsoft also announced its equity investment in SingleTrac Entertainment Technologies, creating a multi-title, long-term deal with exclusive PC publishing rights for Microsoft. See Treasury "New Deals" section for more details.
- Retail distribution for Kids products is shifting toward low-priced bundles as the channel attempts to rationalize shelf space – of 1,751 kids titles in the US, the top 46 sellers generate 50% of all kids software revenue. Stocking of even strong-selling single titles is being replaced by bundles that sell for as little as $29.95 street price. Competitors such as Learning Company, Edmark, and Brodèrbund are all bundling some of their best-selling titles. PJ's Reading Adventure is Microsoft's 3-product bundle in this segment and is being priced, retail, at $29.95.
- PC Magazine picked the top 100 CD ROMs based on content, multimedia innovation, resource requirement, user interface and overall impression. Microsoft titles making this list included Encarta 95, Automap Road Atlas, Cinemania 95, Magic School Bus Explores the Solar System, Dangerous Creatures, Explorapedia World of Nature, and Complete NBA Basketball. Encarta 96 and 3D Movie Maker also won Software Publisher's Association (SPA) Codie Awards.

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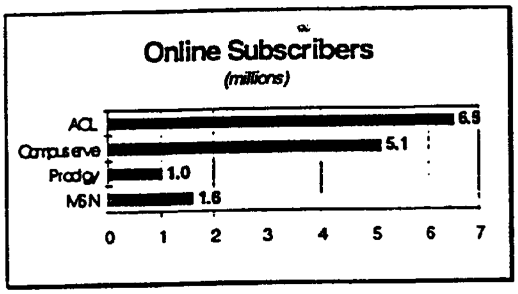
COMPETITION

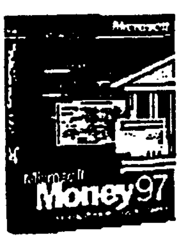
- Online service subscriber growth slowed during Q97-1. As of September 30th. America Online membership grew 7% over the prior quarter-end to 6.5 million. Excluding NiftyServe licenses, CompuServe had a net loss in subscribers for the quarter. ending at 5.1 million. AT&T WorldNet continued steady growth. approaching 500.000 members.



- AOL began testing a flat monthly fee of $19.95 for unlimited use. and also announced the acquisition of multiplayer games innovator The ImagiNation Network. expanding AOL's online game offerings. CompuServe canceled their extensive fall marketing campaign due to financial problems.
- SoftKey International announced it acquired Edusoft, an educational software publisher and developer based in Paris, France. Edusoft publishes and develops a comprehensive line of educational and reference software for use at home and in schools in France and in French-speaking countries.
- GT Interactive announced the purchase of Humongous Software. Humongous, based in Woodinville. develops kids adventure titles such as Putt Putt Saves the Zoo. and Freddie Fish.
- Disney Interactive announced plans to create 15 new "edutainment" titles including a number designed specifically for school use. This would be Disney's first major entry into the mainstream education market.

DESKTOP FINANCE REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS



- Microsoft Money 97 was available in stores on September 30. This new version allows users to pay bills easily. balance accounts more quickly and keep better track of their financial information. Money 97 now includes the Converter Wizard for Quicken that converts Quicken data.
- In conjunction with the release of Microsoft Money 97, Microsoft launched a joint program with Successful Money Management Seminars, Inc. (SMMS) to promote free financial education seminars to the general public.
- Microsoft and Intuit's electronic processing subsidiary (ISC) renewed an agreement to have ISC continue processing online banking and bill payment transactions for Microsoft's Money personal finance software under an expanded multi-year contract.
- MS, in conjunction with a broad list of financial institutions, announced a series of developments in the adoption of Open Financial Connectivity (OFC) within the financial services industry. The OFC specification allows financial institutions to connect directly to the Microsoft Money software program. Currently, 47 financial institutions and solution providers are implementing OFC-based solutions.

COMPETITION

- Intuit announced OpenExchange, an initiative designed to accelerate the adoption of electronic financial data exchange and communication by individuals, small businesses and their financial services providers
- Intuit and CheckFree Corp. agreed to a deal in which Intuit will swap Intuit Services Corp., its back-end bill payment processing unit, in exchange for a stake of about 23 percent in CheckFree
- America Online announced the launch of the AOL Banking Center in the Personal Finance Channel. Eighteen financial institutions have teamed up with AOL to provide secure online banking transactions to AOL members.

- Intuit and Fidelity Investments Retirement Services Co. are developing 401(k) retirement plan management software that will enable employees to download account information from the World Wide Web.
- IBM and fifteen of North America's leading banks announced the formation of Integrion Financial Network. Beginning in early 1997, Integrion will offer a broad range of interactive banking and electronic commerce services to banks in the U.S. and Canada.

HARDWARE REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

- The IntelliMouse, originally planned to release with Office97 will instead be released to market before Office97 and is expected to be on store shelves by November 29. It will be bundled with Internet Explorer 3.0 until the Office97 bundle releases. The IntelliMouse is similar to the ergonomic Mouse 2.0, with a small wheel imbedded in the top. Turning the wheel scrolls text up and down on the monitor screen. Clicking the wheel starts a text "crawl," similar to movie credits going by on the screen, allowing hands-off reading of long documents. The estimated street price is $84.95. Initial shipments include a $20 rebate on the box thus pricing the new Mouse about the same as Mouse 2.0.
- In September the division shipped more than 40,000 units of the Sidewinder 3DPro bundled with Hellbender retailing for $94.95. Also, 16,000 units of Easyball were shipped with Freddie Fish, a Kids title from Humongous Entertainment. The Easyball bundle is targeted at children in the 2-6 age category and includes a $10 rebate on other Humongous titles.
- During this holiday season, Hardware will bring the SideWinder Gamepad to market. Gamepad is expected to be on store shelves by November 7 at an estimated retail price of $44.95. With back-order volumes of 250,000 units, approximately 500,000 units are expected to ship by the end of November.
- A holiday co-promotion with Mindscape was launched to stimulate sales of the Natural Keyboard. The promotion, which ends December 31, 1996, offers a $40 rebate to customers who buy both the Natural Keybaord and Mindscape's "Mavis Beacon Teaches Typing", and a $20 rebate to customers who buy a standalone Natural Keyboard.
- Keyboard inventories have been steadily declining since March, when inventories on hand peaked at 45 weeks. Effective production management in conjunction with KeyTronic, resulted in current inventories at 25 weeks, projected to decline to 10 weeks by March of 1997. Keyboard unit sales have averaged 77,000 per month (all channels) over the past two quarters.
- Hardware is planning to ship 3 Universal Serial Bus (USB) interface products in the summer of 1997 (Mouse, Keyboard, and Joystick). This interface will allow for greater user flexibility,ease of use and will enhance the simultaneous use of more than one input device.

COMPETITION

- Logitech. MS' primary competitor in the input devices market, announced two new products coming out this fall. Surfman Cordless Internet controller, a three-button, thumb-operated handheld device based on radio technology, is designed to make Web browsing "as comfortable as watching TV." The product is available from Logitech's U.S. dealers and distributors at an estimated street price of $99. Also announced was an advanced version of Cordless MouseMan featuring a thumb button and radio technology. The product will ship in October at an estimated street price of $79.
- Logitech's Trackman Marble trackball has taken the trackball industry by storm is estimated to have a 60% share of the trackball business and is on an 800K unit per year pace with revenue per trackball of $60/unit. The Hardware division has started a trackball project to compete with Logitech in this increasingly lucrative market.

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- Advanced Gravis, a competitor in the Gaming Devices category, fielded two tender offers this past quarter. A $6 million tender offer from American Brands was rejected, but in mid- August, the company agreed to support an offer by ACCO World Corporation to purchase all of the outstanding common shares of Advanced Gravis for a price of $.45 per share ($7.65 million.).

- KeyTronic, announced its partnership with Toshiba to manufacture both custom ergonomic keyboards and the industry's first Universal Serial Bus (USB)-driven peripheral, the InTouch Module multimedia control device for Toshiba's new Infinia series desktop PCs. Spokane-based KeyTronic manufactures the Microsoft Natural Keyboard as well as PC peripherals for many large OEMs.

INTERACTIVE MEDIA INVESTMENTS REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

MS NBC

- The Interactive Media Investment Division was created in FY97 to reflect the significant investment Microsoft is making with its interactive media partners and the increased importance of these strategic relationships. The division currently includes MSNBC Cable and Interactive joint ventures, Dreamworks Interactive, and BET. Highlights of Interactive Media investments were covered under the Treasury section of the Board Book in FY96.

- The MSNBC 24 hour news cable channel (Cable JV) and the MSNBC interactive website (Interactive JV) were launched in tandem on July 15th. The MSNBC cable network, with approximately 21 million subscribers at launch date, signed an agreement during the quarter with Time Warner to increase carriage of the network to approximately half of its cable systems. This agreement will increase subscribers by 3 million to 5.8 million by mid 1999.

- MSNBC cable channel will relocate its facilities from Fort Lee, New Jersey to Secaucus, New Jersey in Q97-3. Facilities and set costs are forecasted to exceed the initial plan signed with NBC in April by approximately $17 million for calendar year 97, as costs associated with the move are higher than predicted. The negative facilities variance will be offset by favorable tax consequences of a bond financing agreement with the New Jersey Economic Development Association to provide leasing of capital equipment costs at favorable interest rates. Q97-1 funding for the cable JV was $45 million and Microsoft's share of the joint venture operating loss in the quarter was $24 million . Life to date, Microsoft funding for the Cable JV totaled $86 million and a $38 million operating loss has been incurred.

- Interactive JV, comprised of the MSNBC interactive website and NBC Desktop video businesses, required Microsoft funding of $10 million during the quarter. Life to date Microsoft funding for the interactive JV was $20 million MS has recognized, life to date, an operating loss of $18 million for this joint venture. MSNBC on the Internet headcount totaled 225 Full Time Employee's (FTE) vs. the initial plan of 142. Headcount exceeded plan mainly due to the startup phase of the venture which required extensive use of contingent staff, and higher than plan headcount for operational support to maintain the website. Management is forecasting a reduction to 196 FTE's in FY97.

- Of Microsoft's initial $15 million commitment to the DWI joint venture, $13.5 million has been funded. The first DWI products, The Neverhood", "Someone's In the Kitchen", and "Steven Spielberg's Directors' Chair", have all released to manufacturing and is expected to be on store shelves by November 7, 1996. Goosebumps - Escape from Horrorland was released to manufacturing on October 18, 1996. As of August 31, 1996, DWI headcount equaled 69, with an additional 4 full time equivalent contingent workers..

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PLATFORMS

Q97-1 P&L SUMMARY

($ in millions)	Desktop & Bus. Sys Actual	Desktop & Bus. Sys Plan Var %	IPTD Actual	IPTD Plan Var %	Consumer Plat Actual	Consumer Plat Plan Var %	Softimage Actual	Softimage Plan Var %	Platforms Mgmt Actual	Platforms Mgmt Plan Var %	Total Group Actual	Total Group Plan Var %
Net Revenue	$1,172.3	30.2%	$129.7	28.7%	$0.5	-	$8.8	15.8%	$1.1	-	$1,312.2	30.1%
Cost of Revenue	54.6	10.9%	23.9	10.4%	(0.0)	-	0.5	37.9%	0.0	100.0%	78.9	11.2%
Gross Margin	1,117.7	33.2%	105.8	42.7%	0.6	-	8.3	22.8%	1.1	(731.1%)	1.2	34.1%
% of Net Revenue	95%	-	82%		107%		94%		100%		94%	
Operating Expenses												
People	44.7	6.7%	47.8	5.8%	8.5	20.5%	3.3	12.3%	5.8	30.1%	109.8	8.3%
Infrastructure	15.4	11.6%	15.7	15.7%	3.3	18.8%	1.9	8.1%	2.9	20.2%	38.1	14.2%
Contingency Staff	11.5	14.1%	10.6	(1.8%)	1.9	(2.7%)	0.2	55.0%	0.8	48.8%	25.0	9.5%
Product Development	15.3	32.9%	7.1	50.7%	1.2	(13.6%)	1.1	23.2%	0.6	82.7%	25.3	41.9%
Domestic Product Marketing	10.0	35.5%	14.8	(3.3%)	0.4	58.4%	1.2	7.8%	0.0	-	26.4	17.9%
Other	0.5	nm	0.4	98.5%	0.0	58.5%	0.2	-	0.4	(337.4%)	1.5	88.0%
Direct Controllable Operating Expense	97.4	16.8%	96.2	20.2%	15.3	17.6%	7.8	12.5%	10.5	38.3%	227.3	18.5%
Channel/International Marketing	34.7	19.1%	8.2	27.5%	0.1	87.2%	0.2	58.8%	0.2	78.3%	43.3	22.8%
Product Support Services	43.2	4.6%	10.5	32.4%	0.1	30.4%	0.0	-	0.0	-	53.8	11.7%
Tax, Insurance & Settlement	12.4	(20.2%)	0.3	11.9%	0.0	-	0.0	50.0%	3.0	23.9%	12.7	(18.8%)
Bad Debt Expense	7.3	(38.5%)	0.8	(4.3%)	0.0	-	0.1	(88.8%)	5.1	25.3%	8.3	(31.8%)
R&D Shared Resources	5.9	5.5%	(5.7)	47.1%	3.7	39.0%	0.0	-	(9.8)	42.9%	(0.0)	34.7%
Total Operating Expenses	200.9	11.5%	110.3	23.8%	15.2	20.9%	9.2	14.9%	[illegible]	(47.5%)	338.8	16.4%
Responsibility Margin	916.8	48.8%	(4.4)	93.7%	(15.8)	23.8%	(0.1)	96.8%	0.1	112.4%	896.7	73.4%
% of Net Revenue	78%		(3%)		(2854%)		(2%)		10%		68%	
Corporate Allocations	83.1	22.8%	35.9	23.2%	2.7	21.4%	1.1	79.9%	0.2	27.7%	122.8	24.7%
Contribution Margin	$833.8	65.2%	($40.4)	65.8%	($18.3)	23.5%	($1.2)	86.8%	($0.1)	93.4%	$773.8	118.7%
% of Net Revenue	71%		(31%)		(3353%)		(14%)		(7%)		59%	
Average Headcount	1,815	2.2%	1,969	1.4%	321	13.4%	174	8.2%	261	10.4%	4,538	3.4%
People cost per head	98,548	4.8%	96,818	4.4%	108,334	8.2%	78,357	8.5%	89,818	22.0%	96,807	8.1%
Infrastructure cost per head	33,918	9.8%	31,985	14.5%	40,599	3.9%	44,150	2.0%	43,751	11.0%	34,490	11.2%

BUSINESS RESULTS

- Desktop & Business Systems Division (DBSD) net revenue of $1.2 billion reflected strong sales across the entire product line. Windows 95 revenue of $558 million was the highest since its launch in Q96-1. Windows NT 4.0 launched during the quarter and showed year over year growth of 224% (Server) and 300% (Workstation). SQL Server continued to gain acceptance as reflected by a 48% growth from the prior quarter.
- Internet Platforms and Tools Division (IPTD) net revenue was 29% better than plan based on strong demand for developer tools (Visual C++, Visual Basic, and MSDN). The August Internet Explorer 3.0 release generated over 2.4 million downloads in a six week period.
- Softimage net revenue for the first quarter was $9 million, 16% ahead of plan. This was primarily due to strong 3D sales in Japan and SE Asia, a concentrated sales effort on sales of maintenance contracts, and little cannibalization of the 3D NT business on Irix sales.
- Despite 30% higher than plan revenue, cost of revenue remained $10 million below plan due to a higher than budgeted mix of Windows NT, which carries a high revenue per license, and a higher than budgeted mix of CD-ROM media vs 3.5" disk media.
- Operating expenses for Platforms were 16% favorable to plan for the quarter due to headcount growth below expectations and actual vs budget timing differences for marketing, localization and offsite development expenses.
- The Platforms responsibility margin was $897 million, or $380 million better than plan. Most (80%) of this variance is explained by the strong revenue results.

OUTLOOK

- DBSD revenue is expected to continue its growth trend as localized versions of Windows NT 4.0 are released in Q97-2, and as the Win95/Internet Starter Kit bundle reaches distribution channels prior to the holiday selling season. The biggest driver of DBSD revenue growth will be OEM shipments of Windows 95. We should note increased PC shipments and server applications will help sustain momentum, particularly as SQL Server becomes more widely accepted and as Exchange moves from the corporate evaluation stage to deployment.
- The Internet Platforms and Tools Division plans to release several strategic product offerings during

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FY97. Two new development tools. Internet Studio. an advanced web site development tool. and Visual J++. (a visual development tool based on the Java programming language). are being introduced and targeted at Internet developers. Merchant System (a computing environment targeted at enabling secure WWW commerce) and Normandy (a platform for internet and online service providers) are both first-version releases targeted at the high-growth Internet server applications market segment. In addition, Internet Explorer 4.0 will shift the Internet browser paradigm as it becomes better integrated with Windows Explorer, enabling Microsoft's vision of Active Desktop. Updated versions of IPTD's flagship products. Visual Basic and Visual C++, are also scheduled to be released..

DESKTOP & BUSINESS SYSTEMS DIVISION REVIEW

Server Systems

INVESTMENTS & PRODUCT HIGHLIGHTS

- Windows NT Server 4.0 shipped in August, featuring the Windows 95 interface. FrontPage web authoring tool, improved performance on multiprocessor machines. management wizards, Internet and Intranet communications. and the ability to create secure applications on the web using the Distributed Component Object Model.
- MS and Intel announced a development program to port the Windows NT operating system to Intel's future 64-bit processor family.
- The Distributed File System (DFS) beta for Windows NT Server was made available for free via the Microsoft web. It is a utility for logically organizing multiple file servers and shares into a single directory.
- MS Exchange 4.5 entered beta testing in September at over 250 customer sites. This version features enhanced support for Internet standards which will enable POP3 email clients and Web browsers to access email, scheduling and groupware applications over the Internet. RTM is expected by the end of CY96.
- SMS 1.2 was released in mid August, with enhanced inventory, remote diagnostic, software distribution, and network monitoring capabilities, and with extended internet protocol and tools support.
- SQL Server 6.5 set the industry's first price/performance record below $100 per tpmC (transactions per minute) and set an all-time performance record on Intel-based servers (6751 tpmC).
- In September, Microsoft along with SAP AG, Platinum, ExecuSoft and other industry leaders announced an alliance to deliver simpler and more cost effective data warehousing solutions using MS SQL Server.
- A release candidate for SNA Server 3.0 began shipping in September, with the final release slated for Q97-2. New features include host print services, increased capacity, and data encryption.
- MS Index Server, which allows users to quickly locate documents or text on the Internet, Intranet and file servers became available in September for download via the MS Web site.
- Falcon (message queuing), Denali (server scripting), Viper (transaction processing), and Catapult (Proxy) projects entered beta testing, giving users the technology to easily build secure, scaleable and distributed transaction environments on the Internet. Catapult (MS Proxy Server 1.0) was released to manufacturing on October 16th.

COMPETITION

- In August, Netscape announced a beta version of FastTrack Server for Windows 95. Enabling users to install, configure and publish personal web sites, this product includes support for Java and JavaScript and will be bundled with the Navigator Gold client for $295.
- Netscape announced an agreement with NCR to port its web server applications to MP-RAS, NCR's version of UNIX. NCR will also offer Netscape's FastTrack and SuiteSpot products on the NT Server platform.
- Oracle announced plans for shipping its core product lines for Windows NT Server on Intel, Digital Alpha and PowerPC hardware. The company will also add 150 field sales personnel in the next six months exclusively supporting its Windows NT based customers.

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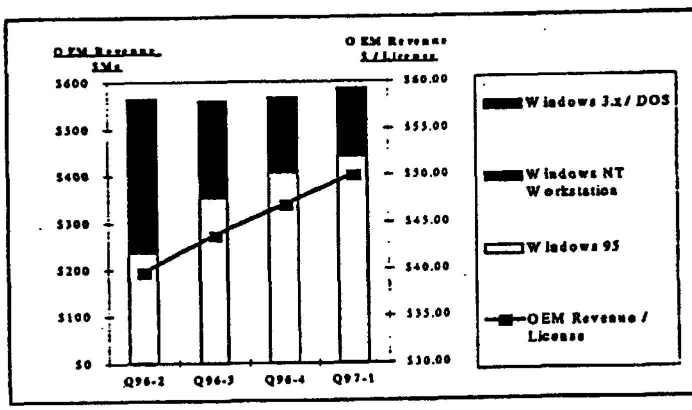
- In September, Oracle acquired Datalogix, a provider of client server solutions for process manufacturing environments. The transaction is structured as a $94M cash acquisition, pending regulatory and shareholder approval.
- Oracle released a beta version of Web Server 2.1 featuring Java support and interoperability with third party HTTP servers, with the final product due later in CY96 priced at $2,495.
- In September, Novell announced IntranetWare, consisting of NetWare 4.11 (code named Green River), NetWare Web server 2.5, Netscape's Navigator browser, protocol gateways and routers for WAN and Internet connections.
- Novell introduced its GroupWise 5 client/server e-mail system in mid-September. This version of GroupWise is being positioned as a cross platform Intranet-enabled tool for e-mail, scheduling, and document management.
- Sun launched its Solstice line of Intranet management software, a suite of cross-platform applications for email and systems management based on Internet standards.
- IBM introduced symmetric multiprocessing support for OS/2 Warp Server at NetWorld +Interop. The technology is optimized for 2-way and 4-way machines, although it is capable of supporting up to 64 processors.
- Lotus announced the availability of "Domino" server technology, which facilitates interactive, Internet standards based application development on Notes 4 servers.

Desktop Operating Systems

INVESTMENTS & PRODUCT HIGHLIGHTS



- Windows NT 4.0 Workstation launched in July continuing the industry's momentum toward the 32-bit Windows family. More than 90 PC manufacturers and software partners have announced their support. New features include the Windows 95 interface, Internet Explorer 3.0, peer web services, and improved management capabilities. To date, 258 thousand Windows NT 4.0 Workstation licenses have been shipped worldwide.
- MS posted a technology preview on the Internet that allows customers to run most Windows 32-bit applications on RISC platforms (PowerPC, Alpha & MIPS) running Windows NT Workstation 4.0.
- Windows 95 posted its strongest sales quarter since initial release driven by continued OEM penetration, US channel reorders, and one-year anniversary and academic promotions. Windows 95 life-to-date sell-through is estimated to be 44 million licenses.
- The Windows 95 OEM Service Release (OSR) 2 shipped this quarter as an update to Windows 95. It is intended to add support for new and emerging hardware and includes Internet Explorer 3.0, NetMeeting, support for the FAT32 file system, and Internet mail and news. OSR 2 will be available on PCs shipping later this year, and some components will be available via the WWW.
- A retail bundle of Windows 95 and the Internet Explorer Starter Kit 3.0 was released in September to create excitement for Windows 95 during the holiday season, and to support broader distribution of Internet Explorer.
- A CD games sampler for Windows 95 was released in September to drive awareness of Windows 95 as a consumer and gaming platform. It will be available through reseller and OEM.

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COMPETITION

- IBM announced the availability of OS/2 Warp 4 in September. This latest version of their 32-bit desktop operating system includes a better user interface, greater connectivity, voice recognition technology, and built-in Java support.
- IBM launched channel education offerings for OS/2 Warp 4 designed for members of its partner program BESTeam which enables VARs, system integrators, network integrators, and consultants to better support IBM desktop and workstation software solutions.
- IBM and Citrix Systems, Inc. announced that Citrix's WinFrame/Enterprise v1.6 multi-user application server software will be supported by Citrix in an OS/2 operating environment. This will significantly expand the breadth of Windows applications available to OS/2 users, including users of OS/2 Warp 4. This support will provide OS/2 users access to 32-bit Windows applications in a network computing environment.
- Apple announced a minor retail upgrade to the Mac OS designed to enhance system stability and deliver some performance improvements. Key features of version 7.5.3 are one-button installation, a revised memory management system, a universal system folder that can boot any Mac from the Plus to current systems, and reduced software installation time.

INTERNET PLATFORMS & TOOLS DIVISION REVIEW

INVESTMENTS & PRODUCT HIGHLIGHTS

- Microsoft released Internet Explorer 3.0 (IE3) on August 13th. IE3 includes AutoSearch (a new search feature), a more intuitive and flexible user interface design, improved encryption, and support for ActiveX, Java and VB Script capabilities. To encourage users to try IE3, Microsoft partnered with several content providers, including ESPNET SportsZone, The Wall Street Journal Interactive Edition, and Hollywood Online, to offer free limited-time subscriptions to their content. More than 1 million people downloaded IE3 in its first week of availability; IE3 browser market share increased to 8% at quarter's end compared to 6% last quarter, as measured by call-downs.

  Recent browser share data is as follows:

Internet Browser Share	As of Sept '96	As of June '96
Netscape Navigator (all platforms)	51%	52%
America Online Browser	21%	20%
Microsoft Internet Explorer	8%	6%
Mosaic	2%	3%
Other Browsers	12%	10%
Unsure	6%	9%
Total	100%	100%

Source: Market Decisions random sampling of 118 users who accessed the WWW in September 96.

- Microsoft also released IE 2.1 for the Windows 3.x and Macintosh platforms in July. Microsoft continued to expand its IE cross-platform strategy by announcing plans for a Unix version to be delivered later in the fiscal year.
- Microsoft announced the Microsoft Internet Referral Server, allowing Windows 95 and Windows NT users the ability to choose and subscribe to an Internet service provider (ISP) directly through IE3.
- Microsoft released the Visual J++ during Q97-1. Visual J++ includes Java Applet wizards, a graphical debugger and a Visual J++ source compiler. Visual J++ is the first Java development tool allowing programmers to extend Java applications with components created in a variety of other programming languages.
- AT&T has agreed to jointly promote and distribute IE3 with its WorldNet Service starting in early fall. Additionally, EUnet International, one of Europe's largest Internet access providers, announced the initial phase of a licensing agreement to offer IE3 as its preferred WWW browser in nine European countries. These companies join an increasing IE partner portfolio, including key Internet access players such as America Online, MCI, and NetCom.
- Microsoft announced plans for fulfilling its Active X strategy by transitioning the management of specifications and appropriate technology to an independent industry standards body.
- Microsoft released a Merchant System beta during the quarter. The product is a secure Internet retailing software which allows merchants to provide online shopping and enable Internet-based credit card payments with limited custom

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development. Microsoft also announced an agreement with VeriFone to deliver a comprehensive Internet retailing solution by incorporating VeriFone's Virtual Point-of-Sale software into Merchant System.

- Microsoft also announced CryptoAPI version 2 beta. CryptoAPI is cross-platform technology which allows developers to add strong security to existing and future software programs. providing underlying technology required to add security features to applications.
- Expanding on both company' Alliance for Enterprise Computing, Microsoft announced Digital Equipment is the first systems integrator to help customers implement its Internet services platform (code-named Normandy). Normandy. an integrated family of scaleable Internet server applications, targets commercial Web sites, Internet service providers and online service providers. and consists of mail. chat, news, information retrieval, personalization, content replication, white pages and merchant server applications.
- MS is expending significant effort to change the current U.S. Government policy on electronic security. The current and proposed policies are untenable both in terms of allowing a market in electronic security that rivals the market in physical security and permitting us to build tools that are competitive worldwide. Until we have a policy that meets our requirements of a level playing field with no trade barriers that enables the channel and small ISVs to deliver and warrant electronic security solutions. we will not invest in government specific needs.

COMPETITION

- Netscape released Netscape Navigator 3.0. a major update to its Internet browser software. Navigator 3.0 integrates new security features and a suite of Web-based applications. including electronic mail, news, and collaboration technology for Internet telephony and shared whiteboards. Included is the Netscape Inbox Direct feature that allows for personalized news, sports. finance and entertainment updates to be posted daily in the Netscape Internet Inbox.
- Recent Netscape communications have articulated a shift in emphasis away from the consumer Internet browser market toward the corporate Intranet market with the announcement of AppFoundry. AppFoundry is a collection of reusable business applications and enterprise development tools for IS professionals building corporate Intranets. The program aims to stimulate Intranet application deployment based on Netscape ONE (Open Network Environment).
- Netscape announced Netscape ONE. a standards-based platform for creating distributed client/server applications. This would unify Internet technologies such as HTTP, HTML, LDAP, Java, into a single platform and open cross-platform software and technologies for creating rich, distributed Internet/Intranet applications.
- Netscape also announced the formation of Navio Communications, an independent Internet software company (Netscape holds a major equity position). Navio will deliver core, scaleable software based on Netscape Navigator technology for a variety of consumer and non-PC products such as televisions, telephones. set-top boxes. game players, and network computers and information appliances designed for homes and businesses.
- IBM announced CommercePOINT, a family of products and services designed to facilitate electronic commerce on the WWW. Components in the new product suite are Net.Commerce (Windows NT & AIX based merchant server), Net.Commerce Payment (an Internet payment system), and Net.Registry, (certification technology to issue digital certificates confirming identities over the Internet).
- Borland International announced a net loss of $14 million or $.45 per share for its first quarter ended June 30, 1996 compared to a net income of $2.8 million or $.10 per share in the prior year quarter. Revenue was $35 million, compared with $54 million in the same quarter last year with decline being attributed primarily to lower than expected sales in the U.S. Borland also announced Whitney Lynn would serve as acting president and chief executive officer and William Miller would return to his role as Chairman of the Board.
- Venture capital firm Kleiner Perkins Caulfield & Byers announced it will be administering a new venture fund to support start-ups developing Internet software using the Java programming language. Investors include IBM, Sun, Compaq, U S West, TCI, Netscape, and Oracle.

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SOFTIMAGE

INVESTMENTS & PRODUCT HIGHLIGHTS

- SOFTIMAGE Softimage 3D v3.5 for NT released with enhanced modeling, animation, and rendering capabilities, as well as with an effects library and special features for game developers. In addition, 45 ISVs have committed to creating plug-in applications for Softimage 3D version 3.5 using the new Softimage software development kit.
- Digital Studio was demonstrated on the Matrox video hardware at IBC in Amsterdam. In addition, Intergraph has committed to adopting Digital Studio to its RAX based video-editing PC. Digital Studio beta is expected in December.
- Softimage's next generation 3D animation product, (code-named Sumatra), was announced at Siggraph. Sumatra is built on top of the Digital Studio architecture. A prototype was shown to a select group of users at a NDA event in September and was very well received.
- Softimage released Toonz v4.0 and announced that future versions of this 2D animation product will be provided by Digital Video, its original creator. Digital Video also announced its plans to develop a future version of Toonz based on the Digital Studio architecture.

COMPETITION

- Alias/SGI showed their future 3D animation product at Siggraph. The product (code-name Maya) is a collection of existing technologies packaged in a compelling UI, and tightly integrated with SGI's new hardware.
- Kinetix/Autodesk's 3D Studio MAX, has hit major road-bumps after its release. Lack of major features such as quality rendering and NURB modeling has prevented it from being adopted by content developers. The switch from MS-DOS to Windows NT and its hardware requirements, slowed down upgrades of installed base.
- Discreet Logic and Avid announced major losses and termination of certain product lines. Macromedia announced its debut in the video editing market with Key-Grip, slated for release in the first half of CY97. Adobe announced its plans to port Premier to SGI's new low-end video platform, the O2. Both Adobe and Macromedia are participating in Apple's initiative to establish QuickTime in the media creation market. Softimage is working closely with the Active-Movie team to stay competitive in this space.

CONSUMER PLATFORMS

INVESTMENTS & PRODUCT HIGHLIGHTS

Multimedia Networks

- NetShow, a server platform that provides live and on-demand multimedia content over corporate networks was released to manufacturing in August.
- An ADSL trial with GTE that provides high speed data capacity thru normal phone lines without impacting phone service was begun in the quarter. @Home, owned by TCI, Kleiner Perkins, Comcast, and Cox, announced a similar ADSL offering through cable systems, with limited availability beginning in October for $35 per month.

Consumer Appliances

- Consumer Applicances PU announced WindowsCE, the operating system for handheld and other sub-PC devices. The first device utilizing WindowsCE will be a handheld unit that supports both keyboard data input and pen-based navigation. And will also be able to share and synchronize information with their Windows desktop counterparts. Initial hardware vendors of the handheld device include Casio, LG Electronics, NEC, and Phillips and over 30

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companies have committed to developing products for this mobile companion device.

- A strategic relationship was formed with WebTV Networks to cooperate in the development of technologies for delivering Internet content to television. WebTV service, expected this year, will be available through hardware terminals manufactured by Sony and Phillips for under $350 per unit plus the cost for Internet access.

Competition

- Sega announced its Saturn Net Link product, a complimentary product to their game console machine that allows web browsing and email via the TV screen. The units are expected to be available in late October for $200 (plus Internet access charges), or as a bundled unit with the Saturn game player for $450.
- Motorola announced PageWriter, a two-way paging device that has a graphical user interface and allows communication via email and fax. It is based on Memos, Motorola's new operating environment for messaging products. SkyTel and PageMart will be the first paging providers to offer PageWriter. The device will be available in the first half of CY97 for approximately $400.
- AT&T announced its Digital PCS service which combines voice, messaging, and paging communications. The TDMA-based service is available immediately in 40 cities, and service packages start at $25/month. The phone must be purchased separately.
- A great deal of evangelism for the "network computer" took place during the quarter. Oracle introduced "Network Computing Architecture", a cross-platform environment for interoperability. IBM announced its version of the NC will be available by the end of the year for about $700 excluding monitor. Acer, in conjunction with a Chinese company (Legend Group), is developing a "basic" computer which will be available late 1997 for about $500.

Broadcast PC

- MS and other computer industry companies are lobbying Congress and the FCC to reconsider the current HDTV proposal. This proprosal, which is strongly backed by the broadcast industry, would set standards that would inhibit the convergence of PCs and TVs.
- MS announced a cross licensing agreement with StarSight Telecast that gives access to enabling technologies for future software products and services on the PC platform. Under the agreement, MS will pay $20 million for a non-exclusive, worldwide license for Starsight's intellectual property, most notably their electronic programming guide.

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LOCALIZATION

FY97 Localization Cost by Division - YTD Actual vs Budget thru September 1996

($ in thousands)	[illegible]		IPTD		OTHER PLATFORMS		DSK		IMD		OTHER APPLNS		TC
	Q97-1 Actual	Q97-1 Plan	Q97-1 Actual	Q97-1 Plan	Q97-1 Actual	Q97-1 Plan	Q97-1 Actual	Q97-1 Plan	Q97-1 Actual	Q97-1 Plan	Q97-1 Actual	Q97-1 Plan	Q97-1 Actual
Headcount	*Note: Actual headcount as of September; FY97 Plan headcount = Year-end headcount*												
Japan	47	53	33	38	15	20	86	98	31	34	2	2	214
Redmond	56	62	49	50	68	74	86	99	3	3	11	9	273
Korea	10	13	9	9	1	3	16	30	0	0	2	3	38
Taiwan	8	11	6	7	2	3	21	22	0	0	0	0.	37
China	4	8	5	7	0	1	.15	21	0	0	1	0	25
Ireland	80	91	61	67	57	62	146	156	32	40	7	7	383
Total	205	238	163	178	143	163	370	426	66	77	23	21	970
Total External Cost	$ 6,253	$ 6,743	$ 3,038	$ 7,078	$ 854	$ 2,205	$ 6,427	$ 13,770	$ 6,091	$ 9,625	$ 598	$ 659	$ 23,261
Total Internal Cost	$ 5,998	$ 7,294	$ 5,014	$ 6,088	$ 5,602	$ 6,975	$ 9,556	$ 12,094	$ 2,818	$ 3,719	$ 534	$ 706	$ 29,522
Total Localization Cost													
Japan	$ 3,572	$ 5,021	$ 1,705	$ 3,430	$ 1,246	$ 1,594	$ 3,655	$ 5,162	$ 1,992	$ 2,724	$ 56	$ 177	$ 12,226
Redmond	2,502	3,055	1,953	3,113	3,531	4,518	4,408	5,127	3,539	6,121	439	458	16,372
Korea	267	411	292	455	25	85	426	885	-	16	33	87	1,043
Taiwan	253	611	252	518	34	92	652	1,036	-	-	-	-	1,191
China	75	232	638	316	12	18	331	508	-	-	-	-	1,056
Ireland	5,582	4,706	3,212	5,335	1,608	2,876	6,511	13,147	3,378	4,484	604	846	20,895
Total	$ 12,251	$ 14,036	$ 6,052	$ 13,166	$ 6,456	$ 9,180	$ 15,983	$ 25,864	$ 8,909	$ 13,344	$ 1,132	$ 1,565	$ 52,783

NOTE: 1) 'Other Platforms' includes: Consumer Platforms Division (YTD=588K); Worldwide Platforms Group (YTD=5868K)
2) 'Other Applications' includes: Desktop Finance Division (YTD=485K); Hardware (YTD=282k); Worldwide Advanced Technology (YTD=365K)
3) External costs include third party product develpmanet and contingent staff. Internal costs include people and infrastructure.

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- MS plans to localize over 1000 projects in FY97. A project is defined as a unique combination of product. version, operating system and language. This definition excludes minor localization efforts such as porting products to additional platforms or localization of retail boxes and printed documentation.
- Localization costs through Q97-1 are 68% of budget. This favorable variance is largely due to a number of key products for the IPTD. DSK and IMD slipping until Q97-2 and Q97-3. The table to the right provides a summary of the major projects in process or released during Q97-1.

Major Localization Projects by Quarter		
	Q97-1	
	of language version	
	In Process	RTM
DSK		
Office 97	34	
Outlook 97	22	
Excel 97	33	
Front Page 97	4	
Access 97	24	
PowerPoint 97	24	
Word 97	34	
IPD		
IE 3.0 for W32		27
IE 4.0 for W32	27	
Normandy 1.0	7	
Merchant 1.0	3	
IE 2.1 for Mac	8	
IE 2.0 for W3.1		19
IE 3.0 for W3.1	27	
Tools (7 products)	24	
DBSD		
WINNT 4.0	2	6
Exchange 4.0	2	3
IMD		
Encarta	2	2
Other Multimedia Titles	49	22

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Product Support

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SALES, MARKETING & SUPPORT

Q97-1 FINISHED GOODS SUMMARY

	North America		Europe		ICON		Far East		Total WW FG	
	ACTUAL	PLAN VAR%	ACTUAL	PLAN VAR%	ACTUAL	PLAN VAR%	ACTUAL	PLAN VAR%	ACTUAL	PLAN VAR%
Net Revenue	$826.1	23.6%	$450.9	13.2%	$155.1	0.1%	$250.6	18.2%	$1,682.7	17.4%
Cost of Revenue	97.4	16.2%	48.8	9.3%	23.4	24.5%	26.8	4.3%	186.4	14.1%
Gross Margin	738.7	30.9%	402.1	16.7%	131.7	6.3%	223.8	21.6%	1,496.3	23.0%
% of Net Revenue	89%		89%		85%		89%		89%	
Controllable Expenses										
People	44.3	11.5%	39.8	13.3%	14.6	19.9%	11.5	10.1%	110.2	13.2%
Contingent Staff	5.1	29.7%	2.3	34.9%	1.1	7.5%	1.6	9.0%	10.2	26.4%
Infrastructure	14.3	17.9%	10.1	18.3%	5.4	16.6%	4.0	7.9%	33.9	16.7%
Other Misc Expenses	7.5	4.0%	4.7	(1.1%)	3.1	20.5%	2.0	(26.3%)	17.3	3.7%
Sales expenses	71.1	13.7%	57.0	14.4%	24.2	18.7%	19.1	6.8%	171.5	14.0%
Marketing	85.7	23.8%	33.2	27.5%	10.6	37.9%	11.6	44.3%	141.1	28.1%
PSS Costs	69.3	14.9%	27.5	16.1%	6.2	15.7%	12.5	11.7%	116.4	14.9%
PSS Revenue	(19.4)	(3.4%)	(7.6)	(17.9%)	(1.5)	(2.0%)	(2.6)	(2.1%)	(31.1)	(7.2%)
MCS Costs	29.2	(1.6%)	11.6	7.8%	2.8	16.4%	1.1	4.1%	43.6	2.5%
MCS Revenue	(29.8)	6.6%	(12.1)	5.1%	(3.3)	(6.5%)	(0.6)	(32.5%)	(45.7)	4.4%
G&A Costs	1.1	(46.9%)	9.4	10.2%	2.6	6.7%	2.1	13.4%	15.2	7.5%
Total Controllable Expenses	206.3	19.7%	119.1	19.3%	41.6	24.7%	43.1	22.1%	410.0	20.4%
Responsibility Margin	532.4	73.2%	283.0	43.7%	90.1	31.3%	180.7	40.5%	1,086.3	54.8%
% of Net Revenue	64%		63%		58%		72%		65%	
Shared Resources	24.7	11.3%	8.4	21.4%	1.5	25.3%	5.1	20.2%	39.8	15.4%
Corporate Allocations	126.7	23.4%	88.3	23.5%	30.2	23.5%	40.7	23.4%	285.9	23.4%
Contribution Margin	$381.1	233.6%	$186.3	162.9%	$58.3	115.3%	$134.9	95.3%	$760.6	170.4%
% of Net Revenue	46%		41%		38%		54%		45%	
Average Sales Headcount	1,617	11.9%	1,350	8.8%	673	17.8%	398	6.5%	4,036	11.5%
People costs per head	109,487	(0.5%)	118,078	4.9%	86,286	2.5%	116,472	3.6%	109,174	2.0%
Infrastructure costs per head	35,349	6.8%	29,884	10.4%	32,339	(1.5%)	40,732	1.4%	33,548	6.0%

CHANNEL HIGHLIGHTS

- FG net revenue for the quarter was $1.68 billion, or $249 million over plan and 16% over Q96-1 results adjusted for the $1.01 billion reserve for excess Desktop 95 inventory. $34 million of the favorable variance to plan was due to foreign exchange rates.
- All 4 geographic areas exceeded net revenue plan. The top 10 net FG revenue subsidiaries were the U.S., Japan, U.K., Germany, France, Canada, Australia, Italy, Switzerland and Sweden. Notably, the U.K. has passed Germany to be the 3rd largest. Australia and France were the only top 10 subs below plan. Aggregated, these 10 subs represent 84% of FG net revenue.
- Gross margin from finished goods for Q97-1 was 89% versus plan of 85%. The positive variance was primarily due to lower product costs and pipe costs.
- Sales expense for Q97-1 was 14% below plan due principally to average headcount being 11.5% below plan. On a per head basis, people costs were 2.3% under plan due to lower than plan travel expenses.
- Marketing expense of $141 million during Q97-1 was under plan by $55 million or 28% primarily due to slower than planned implementation of marketing programs.
- As a percent of net FG revenue, net PSS expense was 6% versus plan of 7%. Gross PSS costs were 15% under plan due to lower incidents and lower headcount. Notably, net PSS costs decreased 10% from the comparable quarter of the prior year.
- Q97-1 responsibility margin was 65%, the most profitable quarter ever and was 16 percentage points above plan and 11 percentage points higher than prior year.

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Worldwide Finished Goods Gross Revenue Ranking - Q97-1: (000.s)

	97 Actual	97 Budget	% of plan	96 Actual	% Growth	% of Total
1 United States	809,776	664,545	121.9%	1,403,615	-42.3%	46.6%
2 Japan	224,207	193,573	115.8%	136,435	64.3%	12.9%
3 United Kingdom	104,637	91,238	114.7%	139,766	-25.1%	6.0%
4 Germany	104,207	94,415	110.4%	184,004	-43.4%	6.0%
5 France	58,697	62,212	94.3%	99,711	-41.1%	3.4%
6 Canada	49,555	41,374	119.8%	89,821	-44.8%	2.8%
7 Australia	36,620	41,398	88.5%	73,048	-49.9%	2.1%
8 Italy	33,448	28,887	115.8%	48,906	-31.6%	1.9%
9 Switzerland	22,848	19,123	119.5%	46,649	-51.0%	1.3%
10 Sweden	22,093	21,278	103.8%	32,189	-31.4%	1.3%
11 Netherlands	21,916	15,171	144.5%	31,068	-29.5%	1.3%
12 Brazil	17,643	19,250	91.7%	17,234	2.4%	1.0%
13 Belgium	16,140	9,948	162.2%	21,277	-24.1%	0.9%
14 South Africa	13,265	10,563	125.6%	14,943	-11.2%	0.8%
15 Spain	12,667	9,764	129.7%	20,007	-36.7%	0.7%
16 Korea	12,544	10,917	114.9%	9,981	25.7%	0.7%
17 Denmark	11,170	11,160	100.1%	16,294	-31.4%	0.6%
18 Austria	10,350	8,133	127.3%	14,110	-26.6%	0.6%
19 Taiwan	9,821	5,777	170.0%	5,165	90.1%	0.6%
20 Mexico	9,694	11,738	82.6%	11,288	-14.1%	0.6%
21 Norway	8,835	9,703	91.1%	12,411	-28.8%	0.5%
22 Finland	8,273	7,471	110.7%	11,753	-29.6%	0.5%
23 New Zealand	7,363	7,115	103.5%	18,070	-59.3%	0.4%
24 Hong Kong	7,111	8,665	82.1%	12,946	-45.1%	0.4%
25 Argentina	6,789	6,234	108.9%	6,225	9.1%	0.4%
26 Portugal	6,711	5,305	126.5%	7,120	-5.7%	0.4%
27 Singapore	6,312	8,872	71.1%	10,633	-40.6%	0.4%
28 India	6,134	4,072	150.6%	3,196	91.9%	0.4%
29 Czech Republic	6,057	4,733	128.0%	4,240	42.9%	0.3%
30 Israel	5,815	4,734	122.8%	3,308	75.8%	0.3%
31 Malaysia	5,450	5,352	101.8%	4,920	10.8%	0.3%
32 Thailand	4,766	4,932	96.6%	4,981	-4.3%	0.3%
33 Poland	4,678	5,076	92.2%	4,977	-6.0%	0.3%
34 China	4,610	2,819	163.5%	1,089	323.1%	0.3%
35 Gulf	4,157	2,496	166.6%	2,719	52.9%	0.2%
36 Caribbean	4,065	4,106	99.0%	4,455	-8.7%	0.2%
37 Chile	3,876	4,120	94.1%	3,541	9.5%	0.2%
38 Saudi Arabia	3,609	2,550	141.5%	740	387.7%	0.2%
39 Russia	3,107	2,421	128.3%	2,959	5.0%	0.2%
40 Colombia	2,975	5,161	57.6%	5,836	-49.0%	0.2%
41 Peru	2,752	2,711	101.5%	1,498	83.7%	0.2%
42 Venezuela	2,461	2,964	83.7%	2,268	9.5%	0.1%
43 Turkey	2,354	2,379	99.0%	2,748	-14.3%	0.1%
44 Hungary	2,352	3,153	74.6%	2,599	-9.5%	0.1%
45 Slovakia	2,089	1,180	177.1%	554	277.3%	0.1%
46 Egypt	2,052	959	214.1%	731	180.7%	0.1%
47 Greece	1,716	1,957	87.7%	1,951	-12.0%	0.1%
48 Philippines	1,454	1,190	122.2%	938	55.0%	0.1%
49 Morocco	1,148	1,496	76.7%	653	75.7%	0.1%
50 Indonesia	1,080	937	115.2%	1,061	1.8%	0.1%
51 Ecuador	1,059	1,136	93.3%	817	29.6%	0.1%
52 Eastern Europe	919	914	100.6%	1,006	-8.6%	0.1%
53 Slovenia	898	1,148	78.3%	1,546	-41.9%	0.1%
54 West Africa	861	798	108.0%	74	1069.2%	0.0%
55 Romania	746	305	245.0%	245	204.3%	0.0%
56 Uruguay	734	761	96.4%	642	14.2%	0.0%
57 L. America Other	699	0	n/a	255	174.3%	0.0%
58 Southern Sub Sahara	689	626	110.1%	687	0.3%	0.0%
59 Indian Ocean Islands	479	410	116.8%	95	402.0%	0.0%
60 Croatia	369	334	110.4%	274	34.6%	0.0%
61 East Africa	323	253	127.7%	400	-19.1%	0.0%
62 Vietnam	114	306	37.3%	27	325.9%	0.0%
Grand Total	1,739,360	1,502,317	115.8%	2,562,694	-32.1%	100.0%

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GROSS REVENUE HIGHLIGHTS

- Q97-1 FG gross revenue was $1.74 billion for the quarter. with all areas except ICON exceeding plan on the strength of strong DAD and DBSD product sales. ICON sales were down after a strong 4th quarter. particularly in licenses (MOLP). and higher than anticipated Desktop applications returns.
- All product divisions except Hardware and Desktop Finance achieved plan for the quarter in the Finished goods channel. Weak sales of gaming devices and returns of Money95 were the main factors in the Hardware and Desktop Finance divisions, respectively, being below plan.
- Finished goods channel sales of Desktop and Business system products were particularly strong in all areas. except ICON. on the strength of Windows 95 (91% over plan), Windows NT Workstation (81% over plan) and Windows NT Server (72% over plan).

Worldwide FG Gross Revenue	North America			Europe			Far East			ICON			Worldwide FG		
	Actual	Budget	% Var	Actual	Budget	% Var	Actual	Budget	% Var	Actual	Budget	% Var	Actual	Budget	% Var
Desktop Apps	414.2	405.5	2%	290.3	271.2	7%	148.7	143.2	4%	95.0	99.9	-5%	948.2	919.9	3%
Interactive Media	24.1	16.6	45%	8.0	9.1	-12%	3.6	2.1	70%	5.2	4.7	12%	40.8	32.4	26%
Hardware	26.2	28.7	-9%	8.7	9.4	-7%	4.1	3.1	32%	4.9	4.8	1%	43.9	48.0	-9%
Desktop Finance	0.9	[illegible]	-50%	(0.1)	2.9	-109%	0.0	0.0	-95%	0.2	0.4	-95%	0.7	2.9	-74%
Total Applications & Content Division	455.2	452.4	1%	305.9	290.6	5%	156.4	148.4	5%	105.1	129.9	-5%	1,033.6	1,001.2	3%
Desktop Systems	177.9	84.8	110%	52.1	38.4	36%	25.3	14.7	71%	17.8	18.4	-3%	273.1	156.3	75%
Business Systems	147.0	100.9	46%	72.3	57.2	27%	42.9	37.1	16%	26.8	25.4	5%	289.0	220.6	31%
Internet Platforms and Tools	57.7	58.9	-2%	22.0	20.1	9%	29.8	14.9	100%	6.1	7.1	-15%	115.5	99.0	17%
Total Platforms Division	382.7	242.6	58%	148.4	115.6	27%	97.9	66.6	47%	50.7	50.9	-1%	677.7	475.9	42%
Other	11.4	11.0	4%	9.9	6.9	43%	4.0	6.6	-40%	2.9	0.8	280%	28.2	25.3	12%
Grand Total	859.3	705.9	22%	463.2	413.1	12%	258.3	221.8	16%	158.7	161.6	-2%	1,739.5	1,502.3	16%

NORTH AMERICA HIGHLIGHTS

- The End User Customer Unit (EUCU) will launch Internet Explorer Starter Kit v3.0 in Q97-2 in retail stores, continue to emphasize Home Essentials, and promote the Office 97 Technology Guarantee. Beginning in Q97-2. a 30 day nationwide (US only) reseller promotion "Are You There Yet" will be launched incenting consumers to purchase leading Microsoft Internet-ready products and receive "MSCash" checks which can be applied to any future purchase of Microsoft product through January 31, 1997.
- This year the EUCU will take advantage of product launch. forecasting. and reporting processes developed over the past year to streamline execution during the Holiday period. Challenges to EUCU include low priced competitive suites, Internet product competition. as well as the replenishment and merchandising execution of Microsoft products on shelf at retailers. Initiatives in the areas of preventing shrink of MS products at retail, alternative distribution. and inventory management strategies are being developed to improve shelf presence and increase sales.
- The Organizations Customer Unit (OCU) will formally launch the Microsoft Solution Provider Program (MSP97) world wide in January. The MSP program has received favorable press from CRN Channel Champions Awards, VAR Business Annual Channel Report Card, VAR Biz Reader's Choice.
- OCU has also launched the "Depth" Partner Program. which will engage 700 partners in the US field, with one-to-one local account management. The goal is to entrench partners with MS focused business models.
- The US OCU field has begun implementation of a structured selling process to medium organizations. The goal is to reach over 12,900 organizations in this manner.
- In Q97-1 over 3,000 organizations attended Microsoft events with over 600 formally evaluating Microsoft software through Solution Providers. The focus on industry solutions continued to result in several significant wins for Microsoft including Burger King who will standardize on Microsoft BackOffice for point of purchase solutions.
- During Q97-1 Enterprise Customer Unit (ECU) large account wins include the Lockheed Martin contract for 120K seats of Exchange; Allstate headquarters standardized on IE 3.0 for 12,000 PCs,(eventually to be rolled-out to the 45,000 agents nationwide) and MS products (NT, NTS, SMS, Windows 95, Exchange and Office).were loaded on 12,000 PCs in Anheuser-Busch

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- ECU campus events included 500 customer IT executives in September attending 35 MS technology and service strategies briefings for large enterprise customers. Also, ECU selected to partner with Forbes for the first MS CEO Summit in Seattle on May 7-9, hosted by Bill Gates with participation from Steve Forbes and 100+ additional top CEOs.

EUROPE HIGHLIGHTS

- The US dollar continued to strengthen relative to most of the European currencies. At the end of Q97-1, the average exchange rate was 5.11 French Francs (FF) and 1.51 Deutsche Marks (DM) for each US dollar in comparison with an average exchange rate of 4.92 FF and 1.43 DM one year ago.
- With the exception of the United Kingdom and the Benelux region, unemployment rates have risen in most European countries and retail sales indicators went down by 10.6 % in Italy, 3.1% in Switzerland, 1.0% in France and by 0.7% in Germany over the last 12 months.
- First half 1996 sales figures of PCs in Europe increased 10% year over year in units with the largest growth in Belgium (+22.4%) and Norway (+21.1%) and the smallest increases in Switzerland (+1.4%) and Spain (+1.6%). With more than 1.8 million units shipped in that period, Germany was still the biggest European market, but it only grew 3.2% while, in the same period, the United Kingdom market increased 11% with more than 1.5 million PCs shipped.
- With the purchase of Merisel in Europe, CHS is now the third largest distributor in the region behind Ingram and Computer 2000. Big US dealers are looking to acquire European dealers. GE Capital acquired Compunet, the largest German dealer and is now looking at ISTA, the top French dealer. In Italy, Olivetti is facing some difficulties due to big losses for the first half of the year and the CEO, Mr De Benedetti, was forced to leave the company. Its PC division is currently for sale.
- Windows NT 4.0 was successfully launched in most of the European countries in September. Research from Computer Intelligence, which tracks large accounts in Europe, showed that a third more corporations were planning to buy Windows NT than all versions of Netware.
- Despite a very slow migration to the 32-bit platform, Spain ended the quarter with gross revenue 30% over plan. The subsidiary signed two important deals with Hewlett-Packard and Telefonica (the Spanish telecommunication company) to promote Internet Explorer 3.0.
- Foundations papers for Romania were finalized, the contract for the office signed and a new General Manager was appointed with operations expected to start in November. The Croatian subsidiary set up will be initiated in November.
- Microsoft Sweden and AST signed a significant agreement with the worker's council of Volvo AB that allows up to 38,500 members to buy PCs bundled with Microsoft software at a discount.
- The United Kingdom has become the biggest subsidiary in Europe, slightly exceeding the German subsidiary for the first time with total finished goods net revenue of almost $105 million.
- Christian Wedell resigned as General Manager of MS Germany.
- Anti-piracy activities continue to be successful across the region. The Belgium police uncovered a large counterfeiting operation of Microsoft products targeted at the Belgium and German markets. More than 90,000 counterfeit OEM version Microsoft products had been produced with another 30,000 Windows 95 in progress.
- SAP was successfully implemented in the United Kingdom in September. Central and Benelux regions will convert during Q97-2.

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FAR EAST HIGHLIGHTS

- The US dollar continued to strengthen relative to the Japanese Yen, with the average exchange rate going from 93.4 Yen per US dollar in Q96-1 to 105.6 Yen in Q97-1. The budgeted rate for FY97 is 115 Yen for each US $. In Q97-1, gross FG revenue for the region was $37 million over plan of which $18 million was due to favorable F/X.

- Localized versions of Windows 95 have added to the continued adoption of Windows as the standard platform in the Far East. The Windows penetration rate (all versions of Windows on Intel PC shipments) in the Far East increased to 83% in FY96, up from 67% in FY95. In FY97, the Windows penetration rate is forecasted to be 88%.

- Japan finished the quarter with gross FG revenue of $224 million and is the second largest subsidiary after the United States. Gross FG revenue for Japan for Q97-1 grew 86% (in local currency) over Q96-1, due in part to the continued adoption of Windows and the success of Business Systems products. MS Japan contributed 13% of Microsoft's worldwide FG revenue in Q97-1.

- PC sales in Japan grew by 62% in FY96 over FY95 driven by lower prices of PCs and software, and easier to use systems. PC sales in Japan are expected to slow to 24% growth in FY97. Estimated PC sales during the last three quarters are basically flat. These estimated sales (units of Intel CPUs) by quarter are as follows:

Q96-1	1,232,000
Q96-2	1,448,000
Q96-3	1,638,000
Q96-4	1,479,000
Q97-1	1,533,000

- Just Systems' Ichitaro for Windows is the leading word processing program in Japan, with an estimated 69% market share of the standalone word processing market in FY96. In Q97-1, Just Systems' shipped Ichitaro for Windows 7.0. Area Hangul's word processor program is the leading word processor in Korea. Area Hangul shipped updated versions of their word processor program and office suite in September 1996. The release of these competitive versions has caused increased pressure on price points and market share for both MS Japan and MS Korea.

- In Q97-1, approximately 60%, (up from 52% in Q96-4) of all Windows 95-capable PCs shipped in Japan were bundled with word processor or spreadsheet software. MS's strategy in Japan is to aggressively pursue bundling Japanese versions of 32-bit Excel and Word with all OEMs. In Q97-1, our market share for this segment was approximately 40%. DAD licenses from this segment represented approximately 32% of all Desktop apps licenses for MS Japan for Q97-1. The combined average revenue per license for pre-installed Word/Excel was $89 (for both products). Q97-1 revenue from this segment was slightly behind plan as the FY97 revenue plan for this segment did not reflect the slow down in PC sales in Q97-1.

- In Q97-1, the Simplified Chinese version of Windows 95 was recalled in the PRC, as a result of anti-communist sayings in the input editor. The impact of the recall is not known at this time, but $200,000 has been accrued in the Q97-1 P&L of MS PRC, for potential costs of replacing product.

- The number of SQL Server licenses sold in Q97-1 in the PRC exceeded the number of licenses sold of this product during the entire FY96.

- Local language versions of Windows NT 3.51 shipped in Q96-3 in Japan and in Q96-4 for the other Far Eastern subsidiaries. The Japanese version of Exchange 4.0 shipped in Q97-1. The fully localized version of SQL Server 6.5 for Japan and DBCS enabled version for the other subsidiaries shipped in Q97-1. The release of these new versions contributed to strong sales in Q97-1.

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ICON HIGHLIGHTS

- MS completed negotiation and signed a contract with Tech Data in Brazil to begin distribution during Q97-3. This is an important step in establishing a consistent and reliable channel partner with proven expertise in a fast growing market. Three of MS' largest distributors in Brazil - Solaris. Compucenter, and Brasoft - had been liquidated through bankruptcies in the past year.
- Localized Desktop 95 products were launched in Arabic and Hebrew during Q97-1. Although delayed. these products were met with considerable interest and demand in their local markets and generated considerable revenues.
- Anti piracy goals continue to be a core business objectives in each subsidiary. ICON has established a central marketing pool of $3 million to assist subsidiary efforts in auditing. marketing and prosecuting piracy issues in their markets.
- SAP installations were completed in Australia in the quarter. Further work underway will see installation completed in New Zealand. Singapore. South Africa. Brazil and Mexico by end of FY97.
- Sonopress succeeded Stream as our manufacturing partner in Brazil. This followed a competitive bidding process at the end of FY96 which saw Sonopress outbid several Brazilian and multinational competitors. Sonopress is a wholly owned subsidiary of the German Bertlesman group.
- Significant investment was initiated in India and SE Asia with the engagment of business development groups focused on particular market segments. The majority of ICON's new headcount in FY97 was targeted at these areas.
- FY96 saw several financing programs introduced in Latin America. particularly in Brazil, in an attempt to use our strong cash position to increase sales. Evaluation of these programs continue following successful introductions and initial periods of trial. A surprisingly low level of delinquency has been experienced so far.

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OEM REVIEW

	Q97-1 Actual	Q97-1 Plan var %
Net Revenue	$743.6	16.2%
Cost of Revenue	24.9	8.9%
Gross Margin	718.7	17.3%
% of Net Revenue	97%	
Controllable Expenses		
People	7.0	12.9%
Contingent Staff	0.3	(107.9%)
Infrastructure	1.7	7.9%
Other Misc Expenses	16.9	(10.2%)
Sales expenses	25.9	(2.1%)
Marketing	1.6	76.9%
PSS Costs	1.5	35.0%
G&A Costs	0.3	27.5%
Total Controllable Expenses	29.3	16.3%
Responsibility Margin	689.4	19.3%
% of Net Revenue	93%	
Shared Resources	0.1	26.9%
Corporate Allocations	122.0	23.4%
Contribution Margin	$567.3	35.6%
% of Net Revenue	76%	
Average Headcount	254	4.5%
People costs per head	110,000	8.8%
Infrastructure costs per head	27,465	3.5%

BUSINESS HIGHLIGHTS

- Q97-1 gross revenue of $745 million grew 43% over Q96-1 and was essentially flat in comparison to Q96-4 revenue of $741 million. All geographic areas exceeded plan. Despite slowing growth in the PC industry, OEM is on track to meet or exceed its FY97 budget of $3.1 billion.
- Windows 95 penetration increased to 74% of the desktop operating system units reported in Q97-1. Higher royalty rates associated with Windows 32-bit operating systems caused revenue to increase at a faster rate than units.
- Another factor in the increased revenue in comparison to units was the growth of the Systems Builders (SB) channel, which pays higher royalties due to relatively low-volume purchases. SB purchases from Delivery Service Partners (DSPs) were $138.8 million, 48% greater than plan.
- Q97-1 Mouse sales totaled 3.1 million units, 13% over budget, despite the existence of counterfeit Mice in several areas of the world.
- Q97-1 cost of revenue was less than plan primarily due to product mix (fewer keyboards sold than budgeted) and lower obsolescence reserves than budgeted. All slow-moving product is adequately reserved for obsolescence.
- Bad debt and B&O tax accruals, which are revenue driven, were the principal reason for Miscellaneous Expenses to have a negative variance this quarter.

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SIGNIFICANT CUSTOMERS

	Q97-1 Actual	Q97-1 Plan	Q97-1 Variance	Growth from Q96-1
Top 10 Multinationals				
IBM	$ 64.7	$ 39.1	$ 25.6	57%
Compaq	47.1	52.7	(5.6)	10%
Dell	46.3	41.0	5.3	92%
Gateway 2000	40.3	47.2	(6.9)	53%
Hewlett Packard	34.9	35.0	(0.1)	117%
Toshiba	28.1	25.1	3.0	106%
Fujitsu	24.6	17.7	7.0	246%
Acer	22.7	17.5	5.2	-4%
NEC	20.7	35.8	(15.1)	-3%
Packard Bell	16.3	30.6	(14.2)	61%
Other Multinationals	66.2	51.4	14.7	-18%
Total Multinationals	412.0	393.2	18.9	34%
Small System Builders	138.8	93.5	45.3	134%
Named Accounts	193.7	155.0	38.7	25%
Gross Revenue	744.6	641.7	102.9	43%
Revenue Adjustments	(1.0)	(1.6)	0.6	NA
Net Revenue	$ 743.6	$ 640.1	$ 103.5	46%

- IBM continues to increase shipments of Windows 95 and is now preinstalling it on the Aptiva and Thinkpad lines. IBM's Windows revenue for the quarter was $54.1 million, an increase of $41.1 million over Q96-1. Due to higher 32-bit Windows royalties, this is the first time in over two years that IBM has ranked first in quarterly OEM revenues.

- Packard Bell and Acer are facing increasing competition in the consumer electronics market from both new and existing OEMs. In July, for the first time ever, Compaq passed Packard Bell for top share in this segment. Toshiba, the market leader in portables, and Sony have both launched desktop lines in the U.S.

- Dell and Gateway 2000 continue to benefit from the efficiencies and flexibility of the direct channel. The build-to-order model allows them to keep low inventory levels, enabling them to bring new technology to the market quicker and at lower cost. As a comparison, Dell and Gateway 2000 each have a total inventory of approximately $200 million whereas Compaq's inventory is $1.5 billion.

- Since its entry into the consumer market in April 1995, Hewlett Packard continues to gain share. It is now number four in the PC superstores, the largest and fastest growing segment of the consumer market.

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PUBLIC NETWORK SALES REVIEW

P&L SUMMARY

	Q97-1	
	Actual	Plan var %
Net Revenue	$1.6	(72.2%)
Cost of Revenue	0.0	100.0%
Gross Margin	1.6	(70.9%)
% of Net Revenue	100%	
Controllable Expenses		
People	2.2	17.5%
Contingent Staff	0.0	47.6%
Infrastructure	0.5	20.7%
Other Misc Expenses	0.0	66.7%
Sales & Marketing expenses	2.8	19.0%
Marketing	0.4	60.2%
PSS Costs	0.0	100.0%
G&A Costs	0.1	32.4%
Total Controllable Expenses	3.3	31.7%
Responsibility Margin	(1.7)	(396.0%)
% of Net Revenue	-110%	
Shared Resources	0.0	-
Corporate Allocations	7.0	24.1%
Contribution Margin	($8.7)	0.7%
% of Net Revenue	-635%	
Average Headcount	69	8.0%
People costs per head	128,580	10.3%
Infrastructure costs per head	31,594	13.6%

PUBLIC NETWORK SALES HIGHLIGHTS

- Q97-1 represents the first revenue quarter for PNS with receipts from the Q96-4 CompuServe deal and MCI's ISDN agreement. Gross revenue was $4M or 72% less than planned due in part to MSN billing system problems and slower than expected ramp-up on the Referral Server Program.
- Glowing product analyst reviews in August and the subsequent IE 3.0 momentum helped fuel the 30 Referral Server Program deals closed across the globe in Q97-1. Key wins include AT&T, British Telecom, Eunet (9 countries), MCI, NetCom, Spry (CompuServe), UUNet (Pipex) and NTT Data. Referral Server Program is an arrangement between an ISP and MS where MS provides end users an opportunity to sign up with the specified ISP via the Windows 95 IE icon (on a server not on the desktop). North America and regions in the Far East are operational and Europe is expected to become operational in October. Estimated activity for late September suggested an average of 3,000 hits per day, however estimates for the conversion rate to sign-ups are not yet available.
- FY97 controllable expenses were 32% below plan primarily due to slower than expected hiring, marketing program launches and PSS usage.
- The PNS business model continues to evolve. However, the fundamental programs supported continue to be specific to Microsoft products, for commercial use, by named PNS accounts such as large telecommunication, cable, ISP or on-line service providers. Although the emphasis may shift from quarter to quarter, the core MS product set continues to be Internet Explorer, Normandy, ISDN, and MSN Access.

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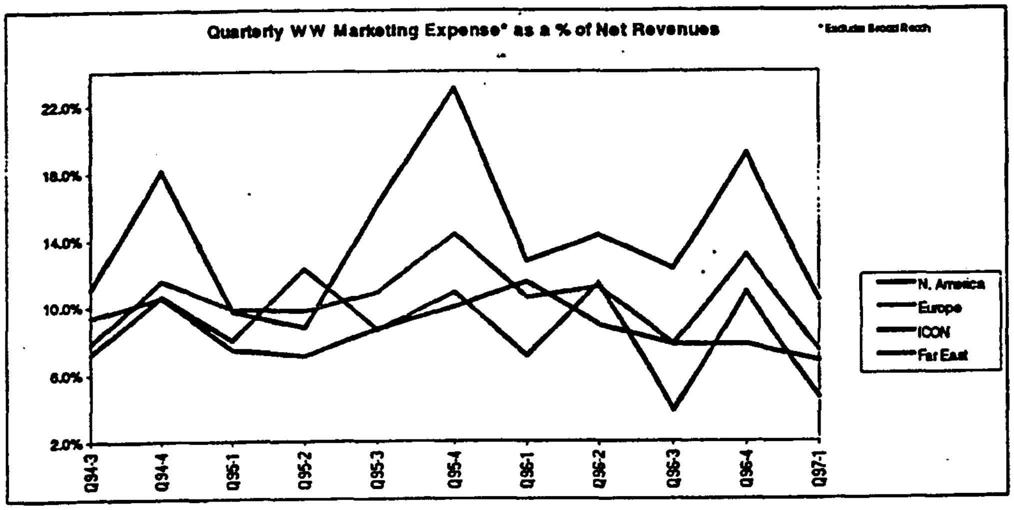
MARKETING EXPENSE REVIEW

Worldwide Net Marketing Expense by Region
U.S. Dollars (in millions)

	Q94-3	Q94-4	Q95-1	Q95-2	Q95-3	Q95-4	Q96-1	Q96-2	Q96-3	Q96-4	Q97-1
North America	$41.7	$83.7	$42.8	$45.3	$68.7	$105.2	$86.4	$96.2	$74.3	$148.6	$85.7
Europe	30.9	43.4	25.0	45.0	46.2	50.1	49.6	69.7	44.3	61.8	33.2
ICON	6.4	8.5	6.6	7.4	8.5	11.4	16.4	11.6	9.8	15.3	10.6
Far East	6.4	6.6	7.7	13.3	11.9	19.7	11.3	24.7	10.9	31.4	11.6
Finished Goods Total	$85.4	$142.2	$82.1	$111.0	$135.4	$186.4	$163.7	$202.1	$139.4	$255.0	$141.1
Year over year increase					59%	31%	[illegible]	82%	3%	37%	-14%
WW Broad Reach	0.0	0.0	3.6	38.6	34.2	24.4	54.7	54.9	18.7	47.2	23.2



- Net worldwide marketing expense for the quarter was $141 million, a decrease of 44% from Q96-4 and a decrease of 14% from Q96-1. The year over year decrease reflects Desktop 95 marketing expenses incurred in Q96-1.
- No region exceeded 77% of its Q97-1 marketing budget and in total, spent 17% of the full FY97 plan

(in thousands)	Q97-1 TOTALS Spend	Q97-1 TOTALS Budget	% Q1 Budget	% FY Budget
North America	85,732	112,495	76.2%	19.5%
Europe	33,248	45,890	72.5%	14.5%
Far East	11,550	20,751	55.7%	14.2%
ICON	10,603	17,074	62.1%	15.5%
FG Subtotal	141,134	196,209	71.9%	17.3%

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MICROSOFT CONSULTING SERVICES

	Q97-1 Actual	Plan	Var
Consultant	$32.3	$33.6	($1.3)
Subcontractors	13.2	10.0	3.2
Sem/Training Fees	0.2	0.2	(0.0)
Net Revenues	45.7	43.8	1.9
People	26.8	30.0	3.2
Infrastructure	6.2	6.7	0.5
Subcontractors	9.9	7.1	(2.8)
Other	0.7	0.9	0.2
Expenses	43.6	44.7	1.1
Responsibility Margin	2.1	(0.9)	3.0
Headquarter Allocations	2.4	3.0	0.6
Estimated G&A	1.8	1.8	-
Contribution Margin	($2.1)	($5.7)	$3.6
MCS Practice Headcount	998	1,109	111
MCS Headquarters Headcount	23	33	10
Practice Revenue/Head	$129	$121	$8
Practice Expenses/Head	$135	$136	$1

BUSINESS INITIATIVES

- A new and expanded version of the Microsoft Solutions Framework (MSF 2.0) was released in September. The new version of the framework shows customers how to evolve information infrastructures effectively to take advantage of emerging technologies, such as Internet- and intranet-enabled applications. MSF is delivered through facilitated training to enterprise customers by MCS and a worldwide network of MSP Authorized Technical Education Centers (ATECs).

BUSINESS RESULTS

- Q97-1 net revenues exceeded plan by $2 million due primarily to increased use of subcontractors. Of the $46 million in revenue, 65% was generated in North America, 26% in Europe, 8% in ICON and 1% in Far East.
- Subcontractor revenue was $3 million above plan for Q97-1 and represented 29% of total revenue. Lower than plan people expense was offset by higher than plan subcontractor expense. MCS utilizes subcontractors to meet business objectives and to meet demand that can not be fulfilled with existing resources.
- Worldwide MCS headcount grew 48% over the same period a year ago, but is 10% below Q97-1 plan. North America experienced 39% growth in headcount, Europe 66%, ICON 59%, and Far East 73%.

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PRODUCT SUPPORT

GROSS PSS COST AND PSS REVENUE FOR FINISHED GOODS CHANNEL

($s in millions)	Q97-1					
	Actual			Plan		
	PSS Cost	PSS Rev	Recov %	PSS Cost	PSS Rev	Recov %
NAFG	$69.4	$19.4	28%	$81.5	$20.0	25%
Europe FG	28.9	7.6	26%	34.4	9.3	27%
ICON FG	6.6	1.5	23%	7.8	1.6	20%
Far East FG	13.1	2.6	20%	14.9	2.7	18%
Total FG	$118.0	$31.1	26%	$138.6	$33.6	24%

NET PSS COST AS A PERCENTAGE OF FINISHED GOODS CHANNEL REVENUE

($s in millions)	Q97-1			
	Actual		Plan	
	PSS Cost	Cost/Rev %	PSS Cost	Cost/Rev %
Interactive Media	$2.5	6%	$3.2	9%
Desktop Applications	30.9	3%	41.7	5%
Desktop Systems	28.9	10%	27.0	14%
Internet Platform & Tools	10.2	8%	14.9	17%
Business Systems	14.4	5%	18.2	8%
Total Net Cost	$86.9	5%	$105.0	7%

BUSINESS HIGHLIGHTS

- Q97-1 Net PSS Costs for the Finished Goods channel totaled $87 million. 17% below plan. These better than plan results along with higher than plan FG revenue resulted in Net PSS costs representing 5.2% of Net FG revenue versus a plan of 7.3% Gross PSS costs of $118 million were 15% lower than plan largely due to less people resources required given that incidents were below plan. PSS revenue of $31 million was 7% below plan primarily due to lower than plan Premier contract revenue.

- Incidents were lower than plan due to a number of factors including the impact of new support policies, actual product mix, and product improvements which reduce the number of incidents per unit. This, combined with increased revenue and a focus on increasing efficiency, resulted in a decrease in net costs of 10% over prior year.

- Domestic Premier customer satisfaction was 96% satisfied in Q97-1 with 62% of customers indicating they were very satisfied. This matches the all-time very satisfied high set during Q96-4.

- Banco Santander became the first customer outside of the United States to purchase Premier Global support. Their headquarters are in Spain with additional support locations in Portugal, Latin America, North America, Hong Kong, and the Philippines.

- Domestic AnswerPoint support increased efficiency by restructuring support delivery mechanisms. Positions have been separated into two tiers with distinct responsibilities. Tier one support engineer's primary responsibility is service delivery to customers with increased productivity goals. Tier two handles more difficult product issues, provides support to tier one, and requires an overall higher skillset. In addition, support engineer phone time has been increased from 6 hours to 7 hours per day to meet productivity benchmarks of outsource vendors.

- AnswerPoint began offering email support for Developer products. Customers using developer products including programming in Access and Office/VBA are now able to submit Standard support requests via email over the Internet

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PRESS

(in thousands)

	Q97-1 Actuals	% Plan	% of NetRev
Net Revenue	19,397	120%	100.0%
Cost of Revenue	6,450	76%	33.3%
Gross Margin	12,947		66.7%
Operating Expenses			
G&A Costs	47	73%	0.2%
Infrastructure	430	66%	2.2%
Marketing Spend	1,123	43%	5.8%
Other Misc Expenses	484	88%	2.5%
People	1,452	68%	7.5%
Operating Expenses	3,538	59%	18.2%
Responsibility Margin	9,409		48.5%
Corporate Allocations			
Allocations	3,609	67%	18.6%
Contribution Margin	5,801	153%	29.9%

- Net revenue for Q97-1 was $19.4 million ahead plan by $1.8 million. Costs and expenses were in line with expectations resulting in a contribution margin of $6 million, 53% over plan.

- As the table below illustrates, the top selling titles for Q97-1 are based on Windows NT 3.51 and Windows 95. Windows NT 4.0 related titles ranked 20th on the list but is expected to see increasing sales in the next quarter. For the top 10 titles, revenue per unit has doubled to $43.43 per unit from $20.64 in Q96-1.

World Wide Microsoft Press
Top 10 Titles Q97-1 vs. Q96-1

No.	Part Description	Oper. Sys	Revenue $	% Of Rev.	Units	Rev/Unit
1	MS WIN NT 3.51 RESOURCE KIT (5 Vol. Set)	Win NT 3.51	1,590,118	9.7%	16,617	95.69
2	NETWORKING ESSENTIALS	N/A	1,429,765	8.7%	28,781	49.68
3	MS WINDOWS 95 TRAINING KIT	Windows 95	1,281,491	7.8%	12,220	104.87
4	MS WINDOWS NT 3.51 TRAINING KIT	Win NT 3.51	1,095,755	6.7%	10,363	105.74
5	WINDOWS 95 RESOURCE KIT	Windows 95	1,039,966	6.3%	44,937	23.14
6	WINDOWS NT TRAINING KIT 3.51 INT'L	Win NT 3.51	420,845	2.6%	4,398	95.69
7	PROGRAMMING WINDOWS 95 WITH MFC	Windows 95	316,793	1.9%	12,160	26.05
8	INTRODUCING MICROSOFT FRONTPAGE	N/A	291,209	1.8%	24,704	11.79
9	PAPID DEVELOPMENT TAMING WILD	N/A	283,199	1.7%	18,794	15.07
10	INSIDE VISUAL C++ (TM) 3RD ED	N/A	239,341	1.5%	10,976	21.81
	Total Q97-1 Top 10 Titles:		7,988,482	48.7%	183,950	43.43
1	WINDOWS 95 RESOURCE KIT	Windows 95	5,768,189	32.6%	218,200	26.44
2	MS WIN NT RESOURCE KIT 3.5 4VPK 2E	Win NT 3.5	1,084,557	6.1%	13,464	80.55
3	MS WINDOWS 95 SBS 2ND ED	Windows 95	981,126	5.6%	67,527	14.53
4	MICROSOFT WINDOWS NT 3.51 TRAINING KI	Win NT 3.51	970,068	5.5%	11,152	86.99
5	UPGRADING TO MS WIN 95 SBS	Windows 95	929,763	5.3%	97,727	9.51
6	ULTIMATE MS WINDOWS 95 BOOK, THE	Windows 95	406,853	2.3%	34,269	11.87
7	MS WORD FOR WINDOWS 95 SBS	Windows 95	345,628	2.0%	22,201	15.57
8	MS EXCEL FOR WINDOWS 95 SBS	Windows 95	303,595	1.7%	19,402	15.65
9	FIELD GUIDE TO MS WINDOWS 95	Windows 95	285,818	1.6%	48,013	5.95
10	MS WORD 6 SBS FOR WINDOWS	Windows 3.11	271,182	1.5%	17,817	15.22
	Total Q96-1 Top 10 Titles:		11,346,578	64.2%	549,772	20.64

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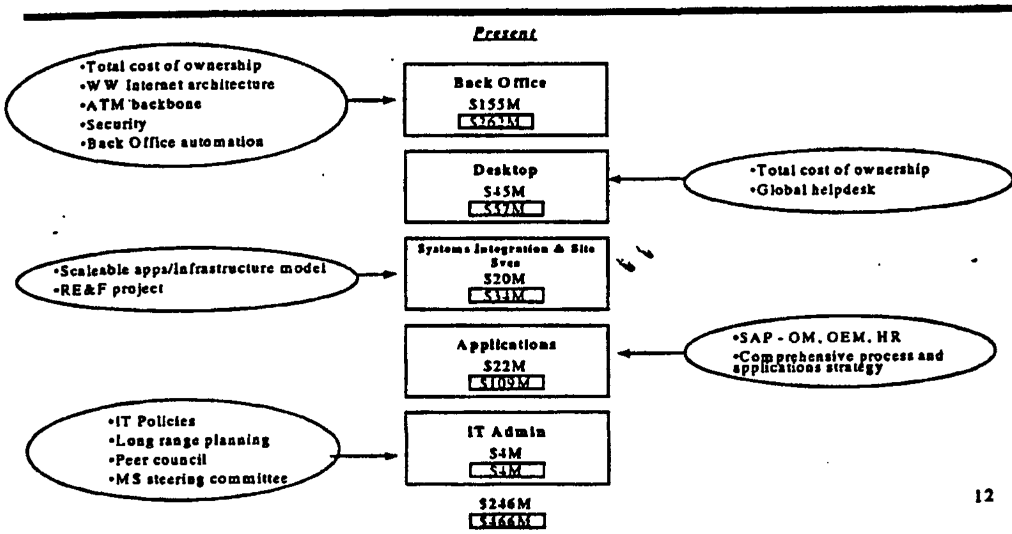
GENERAL & ADMINISTRATIVE

- Total general and administrative costs include functional corporate cost centers that support MS on a worldwide basis such as finance, legal services, and IT project development. Expenses such as employee benefits, facilities costs, infrastructure operation, and adminisrtrative services.are distributed to domestic product, sales, and administrative groups.
- For internal management reports, the remaining net corporate G&A costs are allocated to the channels and product groups as part of corporate allocations.

INFORMATION TECHNOLOGY

- In July John Connors was named Vice President and CIO of Microsoft. The group has subsequently been restructured to more clearly define specific roles and increase accountability. The most significant aspects of the restructuring include the creation of a Worldwide Infrastructure operations group combining oversight of the Redmond computer and network operations function with similar operations at EOC-Dublin, and the move of enterprisewide applications such as SAP into Corporate IT

Major Initiatives



Microsoft Corporate IT major initiatives by reorganized IT business units. Dollar amounts in boxes reflect WW IT costs both within and outside of Corporate IT: amounts above that represent Corporate IT costs included in WW IT costs.

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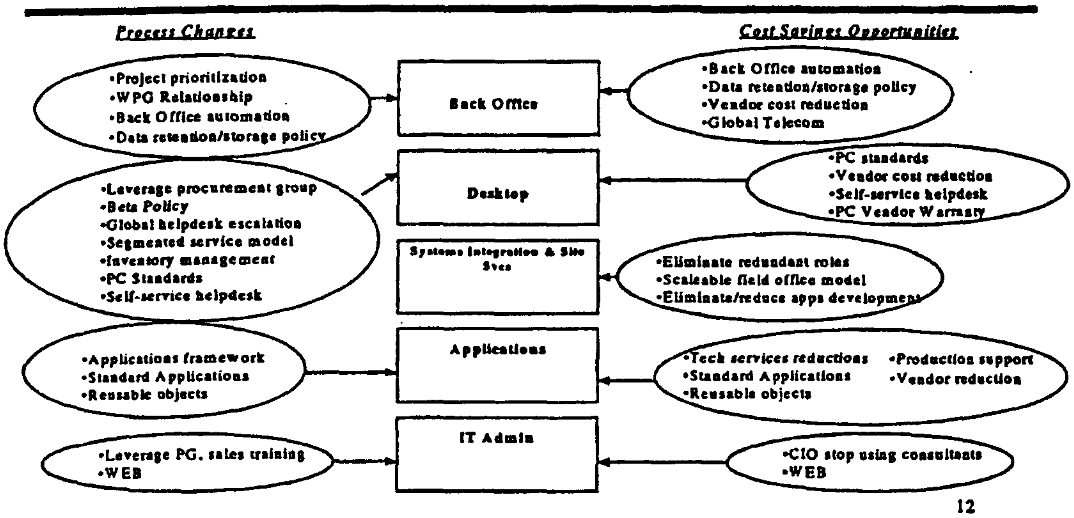
Process Changes and Cost Savings Ideas



- Significant efforts have also been undertaken in Q97-1 to create a business model that more clearly represents the worldwide costs and activities of IT at Microsoft. Work on the model continues during the second quarter to finish identifying drivers of various IT costs and build a consumption view of IT as well as a driver based planning model to forecast IT expense for future periods.
- YTD Corporate IT costs are running below budget due to efforts to minimize headcount additions in IT and slower than budgeted capital acquisitions.

REAL ESTATE & CONSTRUCTION

Worldwide Facility Distribution & Capital Spending

($ in millions, square feet in thousands)

	Facilities Distribution		Q97-1 Capital Spend			FY97 Capital Spend		
Location	Square Feet	Mix	Actual	Plan	Variance	Actual	Plan	Variance
Puget Sound	4,200	55%	$54.5	$59.4	$4.9	$54.5	$59.4	$4.9
Other Domestic	1,301	17%	2.6	3.2	0.6	2.6	3.2	0.6
International	2,095	28%	16.9	35.6	18.7	16.9	35.6	18.7
	7,596	100%	$74.0	$98.2	$24.2	$74.0	$98.2	$24.2

- Worldwide space capacity at September 30 was approximately 7.6 million square feet. In Q97-1 Canyon Park facilities were sold to KAO. Adjacent Canyon Park land still owned by MS is currently being marketed.

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- Construction of Buildings 30, 31, and 32 (Pebble Beach) on the northeast corner of the Campus continued during the quarter and is expected to be occupied in Q97-3. When completed, the buildings will add 365,000 square feet to the portfolio and capacity for 1,500 people. The total cost of this project is $116 million.

- Site work on the Augusta project located between Building 22 adjacent to SR 520 and the southwest section of the main campus began in July. By Q98-3, this $184 million dollar project will add 566,000 square feet to the portfolio. Additionally, a building permit for the 415,000 square feet Troon project has been obtained but work will not commence until space is needed and final approval is obtained. Troon will be located next to Augusta.

- Construction of the Thames Valley Park project in the UK was begun in July 96. The construction site can be monitored real-time through the intranet at http://wsh-01-web/finadm/ltdfacil/watchtvp.htm. Total cost at completion is expected to be $49 million.

- Improvements were started on the Canyon Park Data Center in June 1996. This leased 32,000 square feet building will provide server and telephone expansion for Corporate IT. Premises will be available for occupancy in Q97-2. Total cost of this project excluding Corporate IT equipment is $24 million.

- Improvements for MS Studio commenced in June 1996. Completion is expected in Q97-3 and total costs are estimated at $22 million.

- Building 28, adjacent to Buildings 26 and 27 in the southwest section of Campus will cost approximately $31 million, adding approximately 100,000 square feet to the portfolio. Construction will begin in Q97-2.

Puget Sound Capital Spending

	YTD Actual	YTD Plan	Variance
Committed Projects	$ 48.9	$ 53.1	$ 4.2
Tenant Improvements	3.9	2.7	(1.2)
Furniture & Fixtures	0.1	0.0	(0.1)
New Construction	0.8	1.5	0.7
All Other	0.9	2.1	1.2
Total	$ 54.5	$ 59.4	$ 4.9

FY97 capital spending is tracking close to plan. Tenant improvements for DBSD in Building 24 totaling $3.3 million commenced earlier than anticipated have created $1.2 million in timing overspend. Q97-1 capital spend for the Puget Sound region was on committed projects (such as Pebble Beach, Augusta and the Canyon Park Data Center), tenant improvements on existing buildings (such as remodeling of buildings 1-6) and new construction. New construction represents Campus projects expected to occur through FY98. When completed, over 1.5

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SUMMARY OF DISTRIBUTED G&A COSTS

(in millions)	Q97-1				
	Actual		Plan		% Plan
ITG					
Depreciation	$12.3	32%	$16.3	34%	76%
Maintenance & repairs	1.9	5%	3.6	7%	52%
Telecommunications	5.9	15%	6.6	14%	89%
Outsourcing & Temps	12.2	32%	14.3	30%	85%
Payroll & taxes	7.1	19%	7.2	15%	99%
Other	(1.0)	(3%)	(0.1)	(0%)	nm
	38.4	100%	47.8	100%	80%
Benefits					
Healthcare benefits	14.0	49%	18.0	43%	77%
401(k) match	5.3	19%	5.0	12%	107%
Health clubs	1.7	6%	1.8	4%	95%
Recruiting	5.4	19%	13.0	31%	42%
Other	2.0	7%	3.8	9%	52%
	28.4	100%	41.6	100%	68%
Services					
Copy center	2.0	19%	2.9	22%	68%
Information services	3.1	30%	3.0	23%	103%
Food & beverages	2.5	24%	2.3	17%	109%
Mail center	1.6	16%	2.4	18%	69%
Corporate events	0.4	4%	0.9	7%	44%
Company store	(1.0)	(9%)	(1.1)	(8%)	91%
Travel services	(0.2)	(2%)	(0.0)	(0%)	nm
Other	2.0	19%	2.8	21%	70%
	10.3	100%	13.1	100%	79%
Facilities					
Rent & utilities	6.7	32%	7.4	31%	90%
Depreciation	8.8	42%	8.3	35%	106%
Maintenance & repairs	2.0	10%	2.3	10%	87%
Administrative Services	3.6	17%	3.9	16%	93%
Supplies & Equipment	1.5	7%	1.6	7%	92%
Other	(1.4)	(7%)	0.4	2%	(348%)
	21.1	100%	24.0	100%	88%
Total	$98.2		$126.5		78%

- Distribution costs are categorized as service costs where the distributing group controls the unit cost and the receiving business unit drives unit consumption. For example, Employee Services manages benefit costs per person, but company headcount and their covered dependents drive total benefit costs.

- Distributed ITG infrastructure expenses were under plan in Q97-1 primarily due to $4 million lower depreciation and amortization expense with actual capitalized purchases lagging plan. Contract labor is also under plan in the computer operations and network services group by $2 million partly due to planned contractor conversion to employee status and partly from a lag in contract labor spending.

- Distributed employee benefit costs were significantly under plan in Q97-1 primarily due to lower than planned recruiting costs and healthcare costs.

- Distributed corporate services costs were under plan for Q97-1. The two biggest plan underruns were in the copy and the mail centers. User demand and unit costs were both below plan. The negative amounts in the company store and travel represent the impact of store profits and travel rebates, respectively.

- Distributed facilities costs were about 88% of plan primarily due to lower than planned housed headcount.

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AUTHOR: GREG ALDERSON (GREGALD)

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CAPITAL MARKET ACTIVITIES

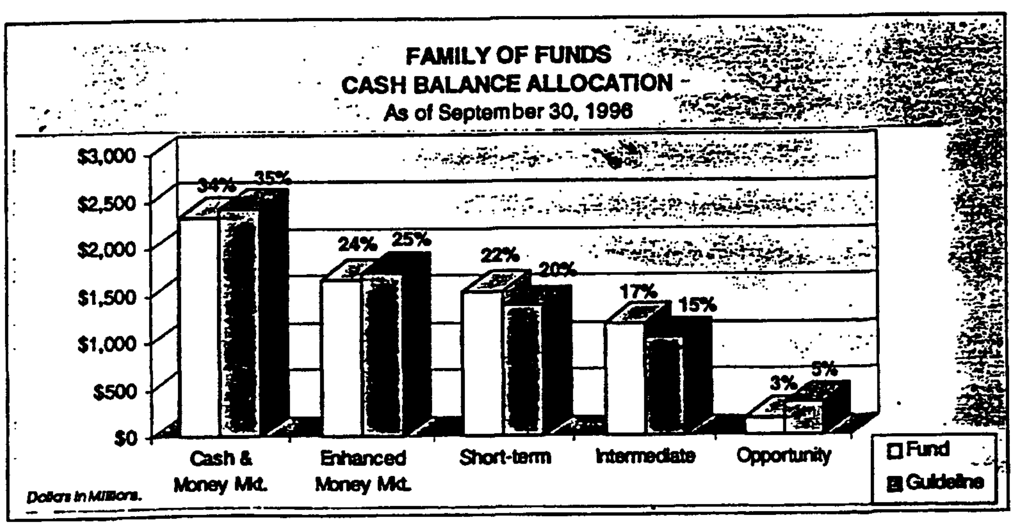
PORTFOLIO MANAGEMENT - FAMILY OF FUNDS

	Cash & Money Mkt	Enhanced Money Mkt	Short Term	Intermediate	Opportunity	Total
Portfolio Allocation:						
Q96-4	32%	22%	23%	20%	3%	100%
Q97-1	34%	24%	22%	17%	3%	100%
Cash Balances (in millions) *:						
Q96-4	2,132	1,510	1,539	1,360	173	6,713
Q97-1	2,337	1,659	1,539	1,185	191	6,912
Total Rate of Return (Pre-tax) **:						
Q96-4	5.76%	5.88%	6.01%	5.47%	9.87%	5.84%
Q97-1	6.01%	6.05%	9.44%	9.87%	7.52%	7.52%

* Market values plus accrued income. Values do not include foreign currency balances.

** Annualized data is provided for illustrative purposes. Past performance is not meant for use as a predictor of future results.

- During Q97-1 Family of Funds allocations and cash balances exhibited an increased emphasis on shorter duration funds.
- The Q97-1 total rate of return vs. Q96-4 increased 1.7% points to 7.5%, reflecting a favorable decrease in interest rates vs. Q96-4's rising rate experience.
- Portfolio economic income corresponds to $.11 per share in Q97-1 on an after-tax basis. This contribution represents a cash flow of $82 million from interest income net of realized losses, plus the value of tax-related and unrealized net gains in market value of $25 million. Unrealized gains and losses are reflected in equity and do not flow through the P&L until realization.



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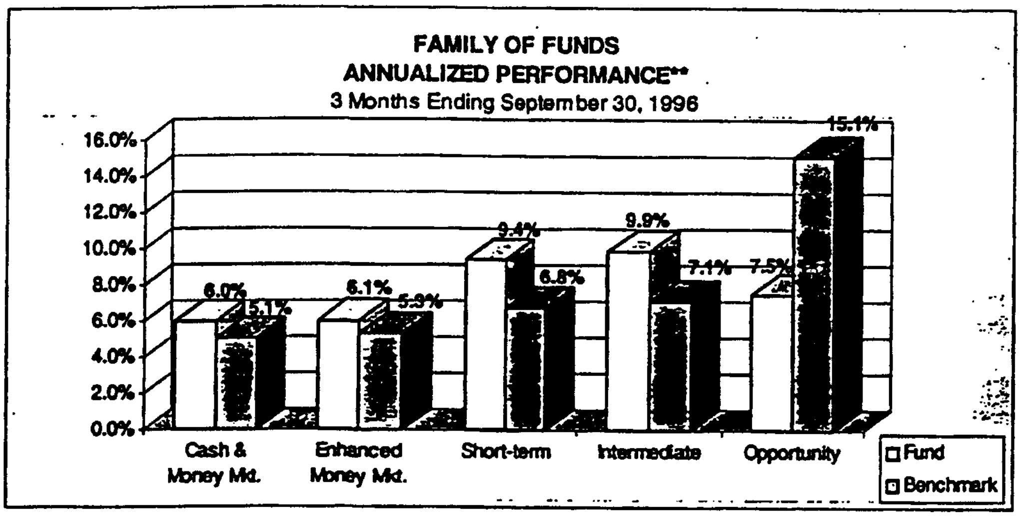

- Abatement in the strength of economic indicators during Q97-1 led the Federal Reserve to maintain rates at current levels. The market, which had significantly priced-in an increase in interest rates, reacted favorably.
- Market interest rates matching the maturities of the MS Family of Funds decreased during the quarter. Specifically, six month US Treasury Bill yields fell 11 basis points to 5.3%, three year US T-Note yields fell 1 basis point to 6.3%, and five year US T-Note yields fell 1 basis point to 6.5%.
- Portfolio durations were positioned at levels at or just below equivalent fund benchmark durations.
- The four Family of Funds portfolio returns exceeded their respective benchmarks for the quarter by a weighted-average of 162 basis points (on an annualized basis). Portfolio returns above benchmarks were primarily generated via security sector and issue selection.
- The Strategic Opportunity Portfolio, which represents about 3% of the total portfolio, delivered an annualized return of 7.5% during the quarter. Returns on many of the securities included in this fund are linked to the performance of MS stock which increased just under 10% during the quarter.

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ACCOUNTS RECEIVABLE

WORLDWIDE ACCOUNTS RECEIVABLE

(in millions)

	DSO				Aging Summary				
	Q96-2	Q96-3	Q96-4	Q97-1	Total	Current	1-30	31-60	60+
Finished Goods									
North America	91	53	34	39	$371	$341	$22	$4	$4
Europe	69	59	43	43	216	169	22	9	16
Far East	49	60	45	64	185	171	9	3	2
AMME	107	101	92	136	28	26	1	0	1
Brazil	202	216	215	318	37	19	3	2	13
India	110	186	155	141	7	6	1	0	0
Southeast Asia	103	109	92	185	20	12	4	2	2
South Pacific	217	214	136	197	67	37	5	14	11
Spanish America	62	65	104	184	41	33	4	1	3
Total Finished Goods	77	65	48	50	972	814	71	35	52
OEM	26	19	19	24	202	168	21	3	10
Other					86	54	10	5	17
Total accounts receivable	61	51	40	46	$1,260	$1,036	$102	$43	$79
						82%	8%	3%	6%
Clearing Acounts					(37)				
Reserves for sales returns					(499)				
Allowance for doubtful accounts					(204)				
Reserves - Other					(43)				
Earned, unbilled revenues					378				
Accounts receivable-net					$855				

- Worldwide gross accounts receivables increased from $955 million at the end of Q96-4 to $1.26 billion. This increase is coupled with improvements in aging from 79% current to 82% current and reduction in "over 60 day" delinquencies from 7% to 6%.
- Worldwide DSO increased from 40 days in Q96-4 to 46 days in the current quarter with deterioration primarily in North America, the Far East and ICON.
- Licensing (Select and MOLP) receivables decreased slightly from $322 million for Q96-4 to $319 million for Q97-1, representing 26% of total receivables, down from 34% for last quarter. Reserves for sales returns increased from $458 million at Q96-4 to $499 million for the present quarter and allowance for doubtful accounts increased from $189 million at Q96-4 to $204 million at the end of Q97-1.
- Negotiations with Tech Data have been completed which will facilitate their entry into the Brazilian market as a major distributor for Microsoft products by February 1, 1997. Solaris, another Brazilian distributor, has made no progress in its efforts to secure appropriate financial support which will probability result in a $5.2 million write-off before the end of Q97-2. This amount has been fully reserved.

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ACCOUNTS RECEIVABLE OF THE TEN LARGEST CUSTOMERS WORLDWIDE

(in millions)

	Total		Aging Summary			
	Balance	Percent	Current	1-30	31-60	Over 60
Ingram Micro	$144	11%	$141	$2	$0	$1
Merisel	79	6%	80	0	0	(1)
Tech Pacific	54	4%	32	5	9	8
Softbank	30	2%	30	0	0	0
GT Interactive Software	27	2%	24	0	3	0
Computer 2000	27	2%	26	1	0	0
Fujitsu	24	2%	23	1	0	0
Tech Data	24	2%	24	0	0	0
Stream International	23	2%	21	1	0	1
IBM	21	2%	21	0	0	0
Total ten largest	453	36%	422	10	12	9
Other	807	64%	614	92	31	70
Total Q97-1	$1,260	100%	$1,036	$102	$43	$79
Total Q96-4	$955		$751	$99	$41	$64
Aging mix of top ten			93%	2%	3%	2%
Aging mix of total			82%	8%	3%	6%
Q96-4 Aging mix of total			79%	10%	4%	7%

- Total accounts receivable for the top ten worldwide customers accounted for 36% of the total at the end of Q97-1, down from 38% at the end of Q96-4.
- Merisel sold their European, Latin American, and Mexican operations to CHS Electronics for $120 million in cash and $34 million in assumed debt. They have agreed to reduce their outstanding bank debt by $72.5 million in return for an extension of their remaining loans. Merisel is working to restructure their debt load to reduce major interest expense and return to profitability beginning in the first quarter of CY97.
- The Escom AG bankruptcy in Germany has resulted in a $5.6 million bad debt write-off during this quarter, while $2 million was received by Microsoft as a bad debt recovery from the 1993 bankruptcy of KLH Technology.
- The newly negotiated contract with Packard Bell reduces their terms to net 60 days with substantial penalties to be triggered if payments are more than 15 days late. They are current as of October 15th. The present outstanding balance is $8.6 million.
- Olivetti continued to report major financial losses, and had a number of management changes during this quarter. They announced plans to exit the computer business, but these are not complete. We have received over $6 million in payments for past due amounts to bring the account to a more current status, with a present outstanding A/R balance of $6.5 million. They are considered to be a high risk account and are fully reserved.

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EQUITY INVESTMENTS & OTHER ASSESTS

(in millions)

	Cost			Market Value (if public)				
Equity Investments	Q97-1	Q96-4	Change	Q97-1		Q96-4		Change
TCI (MOSP J.V.)	$125	$125	–	$123	(a)	$137	(a)	($15)
Wang	83	84	(1)	–		–		–
Mtel	56	55	1	28	(b)	26	(b)	2
Stac Inc.	38	38	–	36		50		(14)
MSNBC	26	28	(2)	–		–		–
Santa Cruz Operation	20	20	–	28		31		(3)
UUNet/MFS	16	16	–	323		276		47
MicroUnity	15	15	–	–		–		–
Lightspan	12	10	2	–		–		–
Individual	11	11	–	12		12		–
Metricom	6	6	–	4		3		1
Tandem	6	6	–	–		–		–
Academic Systems	5	5	–	–		–		–
WebTV	5	–	5	–		–		–
Single Trac	5	–	5	–		–		–
Monotype	1	3	(2)	–		–		–
DreamWorks	1	2	(1)	–		–		–
Citrix Systems	2	2	–	–		–		–
Helicon	1	1	–	–		–		–
ASCII NT	1	1	–	–		–		–
Varstar	–	–	–	38		26		12
	435	428	7	$590		$560		$30
Other equity investments	372	295	77					
Mark-to-market	175	34	141					
Valuation allowance	(86)	(83)	(3)					
Equity Investments	896	674	222					
Other assets								
Intellectual property rights	265	215	50					
Accumulated amortization	(102)	(92)	(10)					
L/T Loans & Other	145	130	15					
Total other assets	308	253	55					

a) Valuation includes 1,388,888 shares of Liberty Media.
b) Excludes MS's 1.4 million warrants in Mtel, 1.1 million of which have certain performance requirements, with an estimated current market value in excess of $5 million.

- Two new minority investments were made during Q97-1, WebTV and Single Trac, for $5 million and $4.9 million, respectively
- Other equity investments increased $77 million, primarily due to the classification of $74 million from "Fund 5" of the MS Family of Funds.
- Total market value of investments in public companies increased $30 million during the quarter primarily due to an increase in the stock price of UUNet/MFS.
- Intellectual property rights increased $50 million during the quarter, due to the signing of a $60 million non-exclusive patent cross-license with Hewlett Packard, offset by the write-off of our investment in Pixar ($5.4 million) and an accelerated amortization of Netwise ($5.2 million).
- Long term loans and other primarily increased due to a $15 million promissory note received from Kao Systems for the sale of Canyon Park.

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HIGHLIGHTS OF CURRENT INVESTMENTS

(See Appendix for additional details)

- Stac announced the formation of a new subsidiary, Hi/fn, which includes the hardware business and will focus on the OEM networking products market. Stac plans to spin-off this subsidiary.
- SCO sent MS a letter in which they want "out" of the 1987 "Centaur" Agreement (originally entered into between MS and AT&T). The Centaur agreement requires SCO to make its UNIX/Intel operating systems "binary(backward) compatible" and requires SCO to pay MS a royalty of $15 per copy. SCO claims that there is no longer any legitimate business reason to maintain binary compatibility and therefore, to continue to pay royalties to MS, and that any MS insistence on keeping the Agreement in force is in violation of anticompetitive/antitrust laws. The legal department is preparing an answer.
- On August 12, UUNET completed its merger with MFS and became a subsidiary of MFS. Each UUNET share was converted to 1.77 shares of MFS. MS currently holds 4.1% of MFS worth $330 million at the October 17 closing. On August 26, MFS and WorldCom, Inc. announced that they had executed a merger agreement under which each share of MFS will be exchanged for 2.1 shares of WorldCom. Upon closing, which is expected to occur four to eight months after signing, MS will hold 15.5million shares of MFS/WorldCom, or 2.2%, worth $336 million at the October 17th WorldCom share price. MS's Network Agreement, which is expected to continue for the foreseeable future with UUNET is being renegotiated to provide for more favorable terms to MS.
- MicroUnity closed its fab on July 2 and sold it to InterConnect. All but 30 people were laid off and MicroUnity is continuing as a "core technology" company.
- Individual Chairman and CEO resigned on 8/7 - Microsoft's investment of $10.5 million in Individual is currently valued at $5.5 million.
- Lightspan raised an additional $20 million in September, 1996 which included $1.8 million from Microsoft. After this additional investment, MS now has approximately 11% of the company.
- Metricom postponed a $75 million convertible debt offering citing weak technology stock prices. Currently, Metricom has about $41 million in cash and short term investments on-hand.
- Academic Systems raised $10 million, of which MS committed to $1 million. It has installed its Interactive Mathematics software on 34 college campuses as of October 15.
- Vanstar, as of September 1 had hired 203 systems engineers and 134 of them had achieved MCSE status.

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NEW DEALS

SINGLETRAC ENTERTAINMENT TECHNOLOGIES, INC.

- On August 28 MS and SingleTrac entered into a Development and Software License Agreement under which SingleTrac will develop up to 10 PC game titles to be published by MS. MS will have exclusive publishing rights to the PC platform.
- At the same time, MS purchased 988,000 shares of Series B Convertible Preferred Stock, for $4.9 million or $5.00 per share. These shares represent 26% of SingleTrac's fully diluted shares. MS also has a seat on SingleTrac's Board of Directors.
- Based in Salt Lake City, SingleTrac developed two best-selling titles for the Sony PlayStation, Twisted Metal and Warhawk. Twisted Metal was named 1995 Game of the Year by *Electronic Gaming Monthly*.

WEBTV NETWORKS, INC.

- On September 13 MS purchased 702,939 shares of Series C Convertible Preferred Stock of WebTV for $5 million or $7.11 per share. The Series C round raised a total of $34 million. The total post-money value of WebTV was $250 million.
- On September 30, 1996 MS and WebTV announced they had entered into a strategic relationship through which they will collaborate on the development of technologies for delivering Internet browsing over televisions. WebTV will integrate elements of MS Internet Explorer technology, adapted for television display, into a future release of the WebTV browser system.

RATIONAL SOFTWARE

- On October 2, 1996, Microsoft sold Microsoft Visual Test, a software quality automation tool, to Rational Software for $23 million in cash. Visual Test enables developers to create tests for applications that run on Microsoft Windows 95 and Windows NT operating systems and the World Wide Web. The divestiture of Visual Test allows Microsoft to focus on development environments such as the Visual Basic and Visual C++ programming systems and the Visual J++ development tool.
- Rational Software is an approximately $1.5 billion publicly traded company that develops solutions for component-based development of software systems.

VDONET CORPORATION LTD.

- On October 28 MS and VDOnet entered into a License & Distribution Agreement under which MS will distribute with Internet Explorer the VDOLive Player, along with the VDOWave video codec, H.263 codec and G.723 enhancements. VDOnet will also distribute NetMeeting and NetShow with its products and will cooperate with MS in a variety of development and video standards setting efforts.
- At the same time, MS purchased 529,000 Class A Preferred Shares of VDOnet at $9.45 per share and received warrants to purchase 776,000 shares at an exercise price of $0.03 per share. MS' $5 million investment represents an 8.8% share of the company's $57million post investment valuation. Other investors, including Nynex, recently invested at a valuation of $127million.
- Based in Israel, VDOnet is a vendor of video networking software for the Internet and Intranet. Its two product lines are VDOLive, a line of client-server software for Internet broadcasting and VDOPhone, an application for video telephony over the Internet and regular telephone lines.

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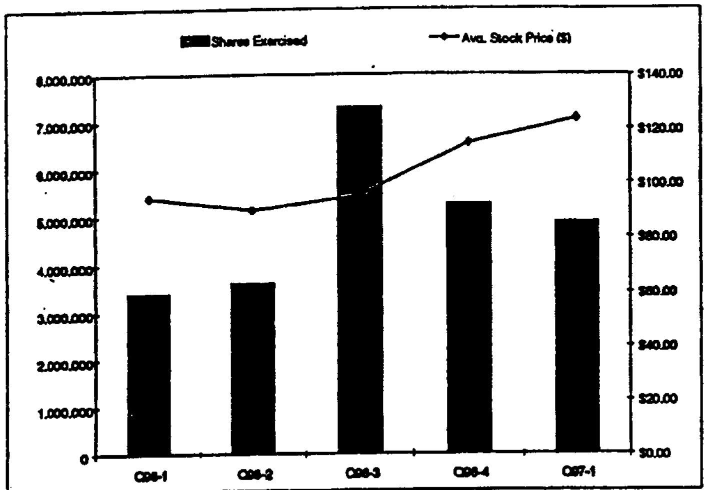
HEDGING ACTIVITIES

STOCK OPTIONS GRANTS AND EXERCISES



- During Q97-1, 689 stock option grants totaling 1.08 million shares were processed for new hires.
- During August Review 1996, a total of 18.6 million shares were granted to 15,481 employees excluding Jumbo participants. The option price was set at $110.62 per share The price for the Strategy Committee (levels 18 and above) was set on 7/15/96 at $118.16. The option price for the strategy committee is based on the average closing price during the 30 calendar days surrounding July 15.
- Cumulative outstanding options on 9/30/96 were 132.5 million with an average price of $54.43. Authorized but unissued options totaled 181 million.
- MS stock traded at an average price of $123.88 during Q97-1. The highest closing price was $138.13 and the lowest closing price during the quarter was $110.63.
- In Q97-1, the number of stock option exercises was 10,018 an increase of 96% over the same period in FY96. The number of shares exercised was 4.8 million, a 44% increase from Q96-1.
- Under the ESPP program, a total of 109,198 shares for the period ending 6/30/96 were issued to 3,765 international employees in 59 subsidiaries at a purchase price of $76.29 per share. Domestic ESPP is reported in even numbered quarters.

STOCK REPURCHASES

- During Q97-1, Microsoft purchased 5.7 million shares at an average price of $125.73. A total of 64.3 million shares have been purchased life-to-date at an average price of $58.86.

	Shares adjusted for all splits	Amount (millions)	Average Cost
FY90	3,570,750	$ 46	$13.07
FY91	10,939,500	197	17.98
FY92	3,969,655	136	34.09
FY93	6,257,000	250	39.96
FY94	8,639,000	348	40.24
FY95	11,669,000	698	59.82
FY96	13,500,000	1,384	102.52
Q97-1	5,794,000	729	125.73
Life to date	64,328,905	$3,786	58.86

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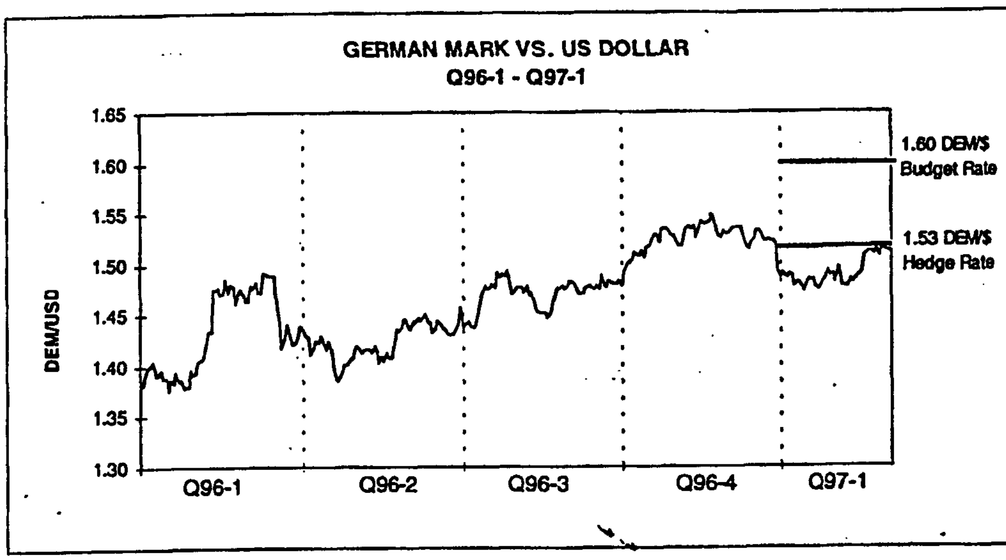
PUT WARRANTS

- At quarter end, 14 million put options were outstanding, with strike prices ranging from $100-$110, and a weighted average strike of $105.21. Maturities range from 6 to 18 months. Life-to-date program proceeds exceed $204 million. $23 million of which represent put options that have expired. Incremental premiums of $32 million were earned during Q97-1.
- This program has enhanced the buyback program by reducing life-to-date stock buyback cost per share by $3.18, from $58.86 to $55.68.
- To recognize the amount that would be required to purchase all 14 million shares at their put option strike prices, a liability of $1.5 billion would be required as an offset to retained earnings; this liability was reduced to $675 million by selling "capped puts" which limit our liability to the difference between the $105.21 weighted average strike price and the "caps" of $57 per share.

FOREIGN EXCHANGE HEDGING



- From the beginning of July to the end of September, the dollar weakened 0.5% versus the major European currencies although it did trade in a relatively wide range, between 1.47DM/$ and 1.53DM/$. The dollar similarly weakened 0.3% versus the Japanese yen during Q97-1, trading between a range of 107Y/$ and 110Y/$.
- In Q97-1, we initiated a rolling 12 month foreign exchange denominated net revenue hedging program. Initially, we bought foreign currency put options to hedge Microsoft's total forecasted FY97 exposure of $1.7 billion. The financial instruments used were average rate put options for seventeen different currencies.
- Treasury also has a continuing program to actively hedge Microsoft's monthly exposure to foreign currency-denominated accounts receivable on a short-term rolling 30 day basis.

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INVESTOR RELATIONS

MSFT FINANCIAL ANALYST RATINGS

Firm	Analyst	Rating
Alex Brown	Mary McCaffrey	Strong Buy
Bear Stearns	N/A	N/A
Cowen & Co	Drew Brosseau	Strong Buy
Dean Witter	Peter Rubicam	Strong Buy
Donaldson, Lufkin & Jenrette	Frank Michnoff	Buy
DMG	Michael Kwatinetz	Buy
First Boston	Esther Schreiber	Buy
Furman Selz	Sanjiv Hingorani	Recommended
Goldman Sachs	Rick Sherlund	Recommended
Hambrecht & Quist	Christopher Gavin	Buy

Firm	Analyst	Rating
Merrill Lynch	Luci Painter	Buy
Montgomery	David Readerman	Buy
Morgan Stanley	Mary Meeker	Market Outperform
Paine Webber	N/A	Buy
Prudential	Lisa Thompson	Buy
Raymond James	N/A	N/A
Roberts, Stephens	Marshall Senk	Buy
Smith Barney	Jonathon Cohen	Favorable
Sound View	Russ Crabs	N/A
William Blair	Laura Lederman	Buy

NOTES:
1. N/A indicates analysts have recently switched firms and are in process of being replaced.
2. New Coverage Initiated: Smith Barney (Jonathon Cohen)plans to initiate coverage the day after Q97-1 with a favorable rating.

INSTITUTIONAL BUYERS AND SELLERS

Top 5 Buyers Q97-1 Institutions	Investment Style	Turnover Rate	Change Since June	September Position
Fidelity Management & Research	Growth	Mod	7,800,000	12,500,000
BZW (Wells Fargo) Investment Advisors	Index	Low	1,765,253	15,500,000
State Street Boston	Index	Low	1,133,983	6,300,000
Friess Associates	Momentum	High	1,009,000	1,009,000
Florida State Board of Administration	Index	Low	697,483	1,782,000
			12,405,719	

Top 5 Sellers Q97-1 Institution	Investment Style	Turnover Rate	Change Since June	September Position
Columbus Circle Investors	Momentum	High	-900,000	2,400,000
Putnam Investment Management	Growth	Mod	-888,000	3,100,000
Ark Asset Management	Value	High	-750,000	250,000
Citicorp	Value	Mod	-675,000	925,000
Loomis, Sayles & Company, Inc	Growth	Low	-667,517	417,000
			-3,880,517	

- For the second quarter in a row, Fidelity was by far the largest purchaser of Microsoft shares. MSFT is now held in 17 distinct funds at Fidelity, up from 3 funds this past Spring. The largest holder is the Magellan Fund (1.5 million shares), reflecting new fund manager Robert Stansky's taste for technology stocks. Fidelity purchased all of its 7.8 million shares for the quarter after the analyst meeting on July 31st.
- Three of the top five purchasers of the stock for the quarter were index funds, which mostly ignore the fundamentals of a company when making a purchasing decision, seeking instead to replicate general market performance.

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- Momentum player Friess Associates jumped into the stock during the July technology sector sell off, spotting strong movement forward from the lowest stock price of the quarter.
- September's buy/sell activity of institutions with more that 250.000 shares reflects almost a 2 to 1 margin of sellers to buyers. While none of these institutions have totally eliminated their MSFT positions. most have taken profits. and two have substantially reduced their holdings.
- September's technology rally and subsequent high MSFT price resulted in Putnam selling nearly 900,000 shares to realize some profit on its position.
- Both Citicorp and Loomis. Sayles & Company sold off their positions during the July downturn in technology stocks. Citicorp increased its position slightly in September sensing the month's rally in technology stocks.
- Ark Asset Management sold the majority of its shares as MSFT no longer fits its criteria as a value stock.

TOP INSTITUTIONAL HOLDERS

Top 15 Institution (Last Quarter's Rank)		Investment Style	Turnover Rate	Change Since June	September Position
1	BZW (Wells Fargo) Investment Advisors (1)	Index	Low	1,765,253	15,500,000
2	Fidelity Management & Research (6)	Growth	Mod	7,800,000	12,500,000
3	Bankers Trust Company (2)	Index	Low	-25,091	7,700,000
4	Alliance Capital Management L.P. (3)	Growth	Low	62,544	6,600,000
5	State Street Boston (5)	Index	Low	1,133,983	6,300,000
6	Provident Investment Counsel (4)	Growth	Low	-290,977	5,000,000
7	Janus Capital Corporation (11)	Momentum	High	439,064	3,700,000
8	Investors Research Corporation (8)	Momentum	High	240,000	3,590,000
9	College Retirement Equities Fund (9)	Index	Low	-103,900	3,242,850
10	Putnam Investment Management (7)	Growth	Mod	-888,000	3,100,000
11	California Public Employees' Retirement System (13)	Index	Low	-25,000	3,000,000
12	Mellon Bank Corporation (18)	Index	Low	179,000	3,000,000
13	American Express Financial Advisors (17)	Growth	Mod	205,588	2,950,000
14	W.P. Stewart & Co. (15)	Growth	Low	-140,092	2,855,000
15	Jennison Associates Capital Corp. (12)	Growth	Mod	-401,950	2,800,000

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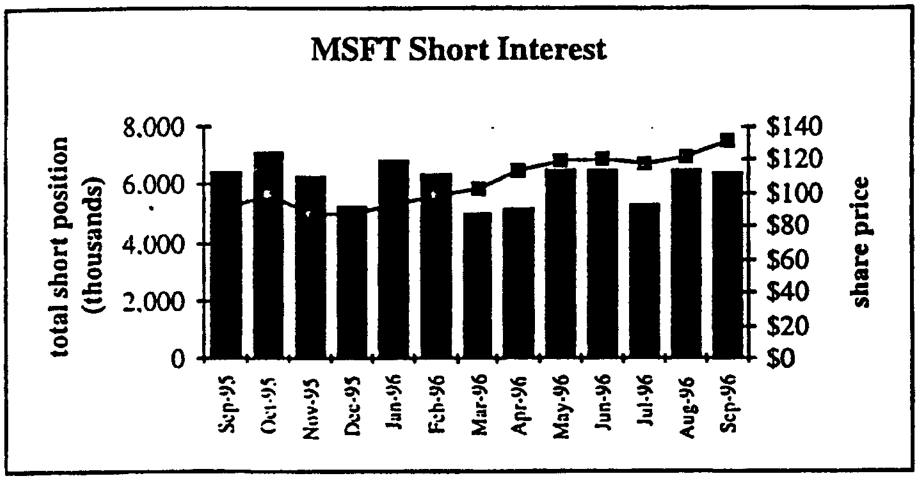
SHORT POSITIONS



- Short interest in MSFT tapered off despite the stock appreciating nearly 8% in September. The total short interest in MSFT was 6.45 million shares at the end of the month. Future Option Deadlines: listed stock options expire October 18.
- Outstanding short positions represents 2.36 days of trading based on Septembers average daily volume. This is a slight increase over June 30th, primarily reflecting lower volume in September than June.

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Industry Watch

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COMPETITOR HIGHLIGHTS

ORACLE ($41 1/2)

- August quarter earnings were in line with analyst estimates at $113 million, or $0.17 per share, compared to $54 million, or $0.08 per share, in the prior year. Prior year results included a $34 million acquisition charge, net of tax.

- Formal announcements on the Network Computer are expected by Oracle during the first week of November. The company's NC will use Oracle software and an Intel chip and is expected to be ready by the end of the year for approximately $500. Larry Ellison, Oracle Chairman, expects total software cost for the machine to be $25 compared to his estimate of $400 for a PC.

- At the Java Enterprise Solutions Event on October 29th, Oracle outlined its strategy to deliver a Java-enabled line of client/server applications by the spring of 1997.

- Oracle introduced Network Computing Architecture (NCA), a cross-platform environment for developing and deploying object-based, network-centric applications. NCA supports the Netscape ONE client, the Network Computer natively, and ActiveX Desktop.

- Analysts viewed positively Oracle's acquisition of the 87% of Datalogix shares it didn't already own for $81 million in cash. Oracle's applications are already integrated with the Datalogix product line which will extend Oracle's customer base into chemical, petroleum, and pharmaceutical producers.

- Oracle outlined its strategy, products and partnerships for enabling secure commerce over the Internet. Products and partnerships included: Project Apollo, a merchant server for small businesses; Oracle Payment Server, a server which delivers a choice of electronic payment methods; Oracle Security Server, authentication software and payment authorization service; and, strategic relationships with CyberCash, Hewlett-Packard, Quark and VeriFone.

SUN MICROSYSTEMS ($58)

- Sun reported September quarter earnings of $123 million, or $0.63 per share, compared to prior year results of $85 million, or $0.42 per share. Earnings exceeded expectations of $0.61 per share.

- On October 29th, Sun displayed its JavaStation network computer which they believe will reduce the three year cost of ownership of a networked PC from $36,000 to $7,500. The JavaStation will include JavaOS and a set of products called "HotJava views" which include desktop productivity applets and the HotJava browser. The operating environment requires 3.5 MB to run applications. An entry JavaStation package with a microSPARCII processor, 8 MB of memory, a keyboard, mouse, and 14-inch XVGA color monitor with no hard drive or floppy drive, will be available in December for $995.

- Sun expects the availability of Solstice Internet Mail 2.0, a Java based email system for network computing, by December 1996. The server will support HotJava views, Exchange and other clients.

- Sun released the JavaBeans application programming interface specification, a component architecture that enables developers to write re-usable components once and run them anywhere, to their web site.

- Analysts see Sun's campaign to make Java the de facto Internet operating and programming language bolstered by IBM's recent endorsement of the thin client/thick server approach to computing; the investment of ten companies, including IBM, Oracle, Netscape, Cisco, TCI, and US West, in a $100 million venture fund to support start-ups developing Internet software using Java; and Sun's "no exceptions" approach to licensing agreements which prevent licensees from tacking on proprietary extensions to Java.

- In order to sustain their 30+% EPS growth into 1998, analysts believe Sun will need to maintain

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its share in the high-end server market; increase software sales to over 10% of total revenues from their current level of 4%; and widen their distribution to reach new vertical markets.

IBM ($125 5/8)

- September quarter earnings of $2.45 per share beat consensus estimates of $2.43 per share and the loss reported a year ago of $0.96 per share. Year earlier results included a one-time charge related to the Lotus acquisition of $3.26 per share. Many analysts lowered earnings estimates for the next year as G. Richard Thoman, CFO, warned that revenue comparisons could be difficult as more customers lease mainframes rather than buy them. Shares outstanding have been reduced 15% since January 1995 with the repurchase of 88 million shares at a cost of $8.7 billion.

- Analysts are positive on IBM's future stock price prospects with the company's rapid refreshing of hardware products, PC products, and storage products and continued significant growth in its services business. Stock price gains are expected due to the stable nature of IBM's new financial model and projected earnings growth of 18% but a forward P/E ratio of approximately 10.

- IBM impressed analysts by winning $11 billion in outsourcing contracts during the quarter. Analysts are aware of the historical tendency for outsource providers to price contracts too low but they believe IBM is turning down low profit contracts and their success will be dependent only on execution.

- Lotus will attempt to gain customer and developer mindshare with a marketing blitz for Domino, the Internet version of Notes. Domino can be used with either Navigator or Internet Explorer. Some analysts believe Domino is 12 to 18 months ahead of Netscape and Microsoft's server software products.

- Formation of the Integrion Financial Network, an alliance with 15 banks representing 60 million households, was viewed positively by analysts. IBM will receive revenue for developing and maintaining the Network which will process electronic banking and commerce. Consumers will be able to choose their own financial software package to use on the Network.

- Using IBM smart card technology, an American Express Corporate Card will be piloted for use with airlines' electronic ticketing capability. Referred to as "ticketless" travel, these smart cards will be initially tested with American Airlines enhanced gate readers, currently installed in 21 airports.

NOVELL ($9 5/8)

- Robert Frankenberg, chairman, president and CEO, resigned following months of criticism for lack of inability to solve a number of pressing marketing problems. John Young, a member of Novell's board of directors and past president and CEO of Hewlett-Packard, was named chairman. Joseph Marengi, formerly executive vice president for worldwide sales, was named president. Young will oversee management of the company until a new chief executive officer is appointed.

- Novell's July quarter earnings of $59 million, or $0.17 per share, were slightly below expectations of $0.18 per share. Prior year earnings, which included the results of WordPerfect, were $102 million, or $0.27 per share.

- IntranetWare, the evolution of NetWare into an intranet and Internet access platform solution, began shipping in October. Existing NetWare 4.1 users receive a free upgrade to IntranetWare.

- Released GroupWise 5, a client/server cross-platform email product which offers document management capabilities that allow single-point access to personal calendaring, group scheduling, tasks, and voice mail faxes from the desktop and via the Internet using GroupWise WebAccess.

- "Everything's connected" is Novell's theme for its new brand-identity campaign. The company will spend $20 million on the campaign which will attempt to paint a more positive portrait of Novell products among decision-making executives.

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NETSCAPE ($46 3/8)

- Netscape reported September quarter earnings of $7.7 million, or $0.09 per share, compared with prior year results of $0.2 million, or $0.00 per share. Earnings exceeded estimates by $0.01 per share while revenues more than quadrupled from the prior year to $100 million. Browser revenue comprised 59% of total revenue for the quarter.

- Announced Netscape ONE (open network environment), a standards-based platform for developers to build a new generation of distributed client/server applications designed for multi-platform Internet/intranets. Netscape ONE combines JavaScript 1.1, Java-based Netscape Internet Foundation classes, and support for a distributed IIOP object model with the Company's upcoming line of Java-based clients, servers and tools.

- Released Netscape Navigator 3.0 which included electronic mail, news, collaboration technology, and Inbox Direct which allows personalized news, sports, and other features directly to the Internet Inbox.

- As part of a strategic agreement, Netscape Navigator will be bundled in Oracle's Intel-based NC software operating environment. Additionally, Navigator will be Oracle's preferred Internet client for selected future products.

- Analysts expect continued explosive growth by Netscape in the near term but are cautious about the last half of 1997. The company is embarking on a strategy of evolving their browser into an email and groupware client called "Communicator" but analysts view this as a new market which requires a more strategic sale and a longer sales cycle. Communicator will include Navigator 4.0, Composer (HTML authoring), Messenger (email), Collabra (group discussion), and Conference (real time collaboration).

- Netscape Navigator will be blended into the interface of IBM's OS/2 Warp 4 operating system.

- Navio Communications Inc. with Netscape as the major equity holder will weave Navigator source code and technology into telephones, televisions, and game machines. Other shareholders include Sony, Nintendo, NEC, Sega and IBM.

COREL ($7 5/8)

- Corel announced pricing plans which will allow corporations to pay $895 for each Windows NT server connected to Corel Office Professional rather than their historical model of charging approximately $200 per user. Michael Cowpland, Corel chief executive officer, estimates the new pricing could save corporations with 1,000 PCs and 20 Windows NT servers as much as $185,000.

- Despite recognizing a one-time gain of $0.10 per share on the sale of its CD Creator subsidiary, Corel missed consensus estimates and reported a loss for its August quarter of $0.05 due to shipping delays of Corel Office Professional 7. Mr. Cowpland anticipates a "very strong profit" in the November quarter but analysts are not falling in line and instead are beginning to have concerns about cash flow.

- A beta version of WordPerfect Office for Java will soon be released and will run on PCs and on a personal digital assistant. Oracle has signed a deal to bundle the Java office on its Internet PC.

- Netscape Navigator will be bundled into upcoming releases of Corel Office Professional 7 and CorelVIDEO Remote.

- Corel licensed the source code to Borland's Paradox, a component of its Office Professional suite, and will assume the responsibility for development, marketing, sales and support of the product.

- Corel's expansion into several diverse product lines (graphics, Java-enabled applications, PDA's, and productivity for clients and servers) has analysts reducing estimates due to increased expenses.

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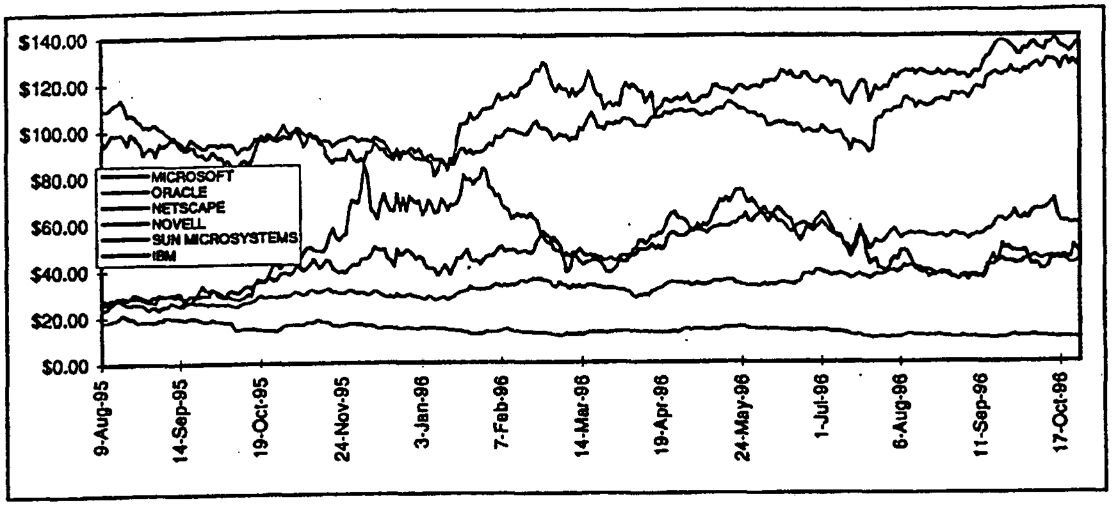
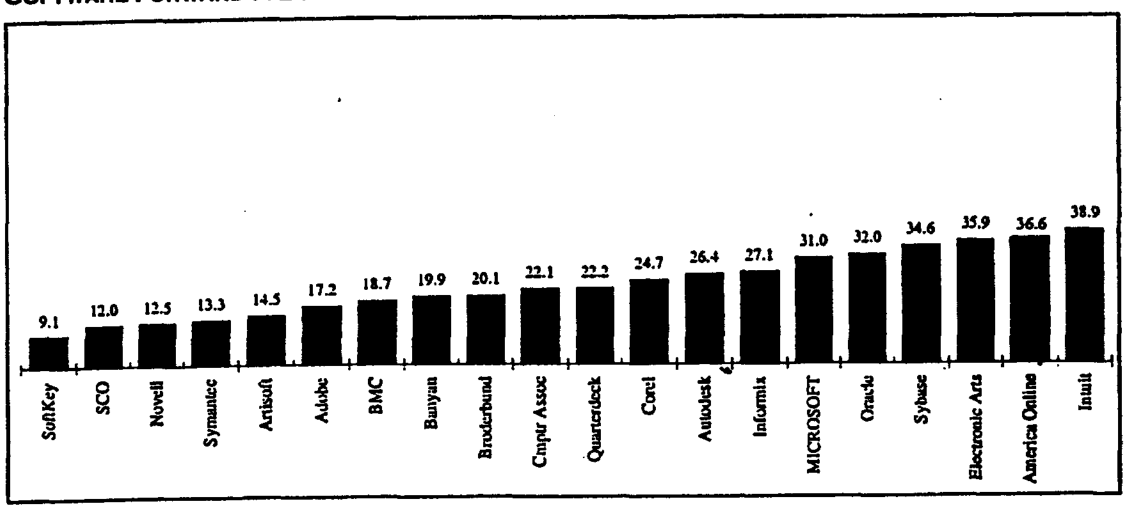
KEY COMPETITOR STOCK PRICES



SOFTWARE FORWARD P/E RATIOS



a) Forward P/E ratios were calculated based upon September 30, 1996 stock prices and analyst's consensus estimates for the next four quarters.

b) The P/E ratio for Netscape (87.5) was excluded to maintain a normal scale.

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INDUSTRY REVIEW

SOFTWARE COMPANIES

(in millions)

Income statement	Adobe 8/30/96	America Online 6/30/96	Artisoft 9/30/96	Autodesk 7/31/96	BMC 6/30/96	Banyan 6/30/96
Most recent quarter						
Net revenue	$181 (a)	$334	$11	$129	$126	$30
Net income (loss)	30	16	(3)	11 (e)	27 (f)	0
EPS	0.40	0.14	(0.23) (c)	0.22	0.51	0.01
Trailing twelve months						
Net revenue	$780	$1,094	$57	$520	$462	$119
Net income (loss)	74	32 (b)	(22) (d)	65	105 (g)	(21) (h)
EPS	0.99	0.34	(1.53)	1.34	2.00	(1.24)
Net income (loss) as a % of net revenues	9%	3%	(39%)	13%	23%	(18%)
Balance sheet						
Cash	$489	$129	$16	$193	$90	$14
Other current assets	151	142	26	148	107	42
Other assets	301	688	14	170	448	41
	$941	$959	$56	$511	$645	$97
Liabilities	$197	$446	$8	$183	$229	$52
Equity	626	513	48	328	416	45
	$941	$959	$56	$511	$645	$97
Other data						
Closing stock price (Sept. 30, 1996)	$37.25	$43.75	$8.75	$25.88	$79.50	$5.38
Common shares outstanding (in millions)	74	115	15	48	53	17
Market value (in millions)	$2,757	$5,031	$131	$1,242	$4,214	$91
Price/revenue ratio	3.5x	4.6x	2.3x	2.4x	9.1x	0.8x
Price/earnings ratio - trailing twelve	37.7x	128.1x	n/m	19.3x	39.7x	n/m
Price/earnings ratio - future 4 qtrs.	17.0x	46.5x	21.9x	14.7x	9.5x	22.0x
Headcount (most recent disclosure)	2,319	5,000	363	1,894	1,444	692
Net revenue/employee (in thousands)	$336	$219	$157	$274	$320	$172
Book value per share	$8.46	$4.46	$3.20	$6.83	$7.85	$2.65
Price/book value ratio	4.4x	9.8x	2.7x	3.8x	10.1x	2.0x
Growth statistics (over comparable quarter):						
Revenue	(1%)	120%	(26%)	(8%)	35%	0%
Research and development	(2%)	273%	91%	18%	27%	(4%)
Sales and marketing	1%	130%	9%	10%	53%	(23%)
General and administrative	12%	105%	6%	(4%)	33%	(8%)
Net income	(12%) (a)	160%	(830%) (c)	(60%)	(1%)	106%

a) Adobe's current quarter reflected slowness in Macintosh software sales and new product shipment delays.
b) AOL's trailing twelve months included $17.8 million in write-offs for purchased R&D. AOL also announced they will take a $385 million charge to write-off capitalized marketing expenses and a $75 million restructuring charge in their September quarter.
c) Artisoft's current quarter included charges of $0.08 per share for restructuring charges.
d) Artisoft's trailing twelve months included charges of $26.8 million relating to acquisitions including Stylus Innovation.
e) Autodesk's current quarter included a $3.2 million charge for in-process R&D from the Teleos Research acquisition.
f) BMC's current quarter included an $11 million write-off of in-process R&D.
g) BMC's trailing 12 months included acquisition charges of $23 million.
h) Banyan's trailing 12 month results included after tax charges of $11 million.

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SOFTWARE COMPANIES - CONTINUED

(in millions)

	Borland 9/30/96	Broderbund 8/31/96	Computer Assoc. 6/30/96	Corel 8/31/96	Edmark 9/30/96	Electronic Arts 9/30/96
Income statement						
Most recent quarter						
Net revenue	$36 (a)	$32	$792	$85 (g)	$7	$129
Net income (loss)	(10)	(4) (c)	120	(3)	(1)	6
EPS	(0.31)	(0.20)	0.32	(0.05) (g)	(0.10) (i)	0.11
Trailing twelve months						
Net revenue	$181	$186	$3,719	$271	$32	$567
Net income (loss)	(15)	37 (d)	(25) (e)	(10)	1	43
EPS	(0.47)	1.72	(0.07)	(0.16)	0.16	0.78
Net income (loss) as a % of net revenues	(8%)	20%	(1%)	(4%)	3%	8%
Balance sheet						
Cash	$84	$151	$203 (f)	$2	$25	$152
Other current assets	26	25	1,045	160	9	155
Other assets	117	24	3,628	212	10	135
	$227	$200	$4,876	$375	$43	$442
Liabilities	$78	$34	$3,283	$92	$4	$105
Equity	149	166	1,593	283	40	337
	$227	$200	$4,876	$375	$43	$442
Other data						
Closing stock price (Sept. 30, 1996)	$6.88	$29.00	$59.88	$8.88	$13.63	$37.38
Common shares outstanding (in millions)	31	21	379	70	7	55
Market value (in millions)	$213	$609	$22,693	$621	$90	$2,056
Price/revenue ratio	1.2x	3.3x	6.1x	2.3x	2.8x	3.6x
Price/earnings ratio - trailing twelve	n/m	16.8x	n/m	n/m	85.3x	48.0x
Price/earnings ratio - future 4 qrts.	n/m	18.8x	19.4x	23.6x	45.5x	26.8x
Headcount (most recent disclosure)	900 (b)	438	9,000	594	209	1,500
Net revenue/employee (in thousands)	$201	$425	$413	$456	$153	$378
Book value per share	$4.81	$7.90	$4.20	$4.04	$6.01	$6.13
Price/book value ratio	1.4x	3.7x	14.2x	2.2x	2.3x	6.1x
Growth statistics (over comparable quarter):						
Revenue	(29%) (a)	(13%)	37%	37% (h)	(2%)	37%
Research and development	16%	5%	23%	180%	6%	36%
Sales and marketing	(4%)	24%	27%	82%	43%	30%
General and administrative	n/a	(9%)	68%	120%	40%	58%
Net income	(471%) (a)	(158%) (c)	35%	(123%)	(383%) (i)	97%

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a) Borland's current quarter reflected slower than expected client/server and Internet/intranet software sales.
b) Borland announced cost reduction measures intended to produce annual savings of $15 to $17 million.
c) Broderbund's current quarter included an $8 million write-off for in-process technology relating the the T/Maker acquisition.
d) Broderbund's trailing 12 months included a $16 million break-up fee from the terminated merger with The Learning Company.
e) Computer Associates' trailing twelve months included purchased R&D charges of $808 million for the Legent acquisition.
f) Computer Associates announced it would purchase Cheyenne Software for $1.2 billion in cash.
g) Corel's current quarter suffered from an Office shipping delay and included a $0.10 per share gain on the sale of a subsidiary.
h) Corel's current quarter included WordPerfect. Prior quarters will not be restated since the acquisition was a purchase, not a pooling.
i) Edmark's current quarter includes $0.03 in charges related to a bankrupt customer and management transition costs.

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SOFTWARE COMPANIES - CONTINUED

	Informix	Intuit	Microsoft	Netscape	Novell	Oracle
Income statement	9/29/96	7/31/96	9/30/96	9/30/96	7/27/96	8/31/96
Most recent quarter						
Net revenue	$238	$91	$2,295	$100	$365	$1,052
Net income (loss)	26	(22)	614	8	59	113
EPS	0.17	(0.48)	0.95	0.09	0.17	0.17
Trailing twelve months						
Net revenue	$886	$546	$8,951	$271	$1,472	$4,504
Net income (loss)	103	(21)	2,309	16 (b)	126 (c)	662
EPS	0.68	(0.47)	3.60	0.18	0.34	0.99
Net income (loss) as a % of net revenues	12%	(4%)	26%	6%	9%	15%
Balance sheet						
Cash	$250	$198	$7,098	$98	$994	$996
Other current assets	289	82	1,134	105	523	1,239
Other assets	291	138	2,508	129	430	1,096
	$830	$418	$10,740	$332	$1,947	$3,331
Liabilities	$316	$119	$3,463	$133	$441	$1,335
Equity	514	299	7,277	199	1,506	1,996
	$830	$418	$10,740	$332	$1,947	$3,331
Other data						
Closing stock price (Sept. 30, 1996)	$27.88	$31.50	$131.88	$62.25	$11.00	$42.38
Common shares outstanding (in millions)	156	46	647	88	352	674
Market value (in millions)	$4,349	$1,449	$85,323	$5,478	$3,872	$28,561
Price/revenue ratio	4.9x	2.7x	9.5x	20.2x	2.6x	6.3x
Price/earnings ratio - trailing twelve	41.3x	n/m	36.7x	344.2x	31.9x	42.6x
Price/earnings ratio - future 4 qrts.	23.7x	48.7x	48.7x	177.9x	20.4x	20.4x
Headcount (most recent disclosure)	1,718	3,474	20,537	1,150	5,737	19,945
Net revenue/employee (in thousands)	$515	$157	$436	$235	$257	$226
Book value per share	$3.29	$6.50	$11.25	$2.26	$4.28	$2.96
Price/book value ratio	8.5x	4.8x	11.7x	27.5x	2.6x	14.3x
Growth statistics (over comparable quarter):						
Revenue	30%	26%	14%	329%	(32%) (d)	36%
Research and development	41%	15%	43%	240%	(33%)	39%
Sales and marketing	32%	43%	1%	272%	(16%)	29%
General and administrative	36%	(29%)	37%	223%	(13%)	36%
Net income	10%	(1436%) (a)	23%	4,275%	(42%) (d)	110% (e)

a) Intuit's comparable quarter included the Microsoft termination fee of $41 million.
b) Netscape's trailing 12 months included charges of $6.1 million, or $0.06 per share, for acquisitions.
c) Novell's trailing twelve months included a $0.04 per share gain on the sale of WordPerfect to Corel.
d) Novell's comparable quarter included $89 million of revenue from sold and discontinued business lines. NetWare revenues decreased from $295 million a year ago to $216 million in the current quarter.
e) Oracle's comparable quarter included a $34 million after-tax charge for the purchase of in-process R&D.

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SOFTWARE COMPANIES - CONTINUED

(in millions)

	Quarterdeck	Santa Cruz Operation	SoftKey (e)	Sterling	Sybase	Symantec
Income statement	6/30/96	9/30/96	9/30/96	6/30/96	9/30/96	9/30/96
Most recent quarter						
Net revenue	$16 (a)	$55	$90	$174	$250	$109
Net income (loss)	(23)	4	(93) (f)	29	(53) (i)	1 (j)
EPS	(0.73)	0.11	(2.08)	0.80	(0.69)	0.02
Trailing twelve months						
Net revenue	$125	$208	$285	$660	$1,011	$445
Net income (loss)	(20) (b)	(22) (c)	(402) (g)	231 (h)	(78)	12
EPS	(0.66)	(0.61)	(11.13)	7.88	(1.04)	0.22
Net income (loss) as a % of net revenues	(16%)	(11%)	(141%)	35%	(8%)	3%
Balance sheet						
Cash	$14	$55	$104	$747	$156	$140
Other current assets	29	47	97	191	260	94
Other assets	34	65	493	260	306	64
	$77	$167	$894	$1,198	$722	$298
Liabilities	$54	$65	$701	$294	$330	$109
Equity	23	102	193	904	392	189
	$77	$167	$894	$1,198	$722	$298
Other data						
Closing stock price (Sept. 30, 1996)	$6.88	$6.63	$19.38	$76.38	$14.88	$10.88
Common shares outstanding (in millions)	32	38	45	36	76	55
Market value (in millions)	$220	$252	$872	$2,750	$1,131	$598
Price/revenue ratio	1.8x	1.2x	3.1x	4.2x	1.1x	1.3x
Price/earnings ratio - trailing twelve	n/m	n/m	n/m	9.7x	n/m	49.0x
Price/earnings ratio - future 4 qtrs.	20.4x	14.8x	9.8x	23.1x	59.1x	14.2x
Headcount (most recent disclosure)	1,060	1,205	775	3,700	2,528	1,442
Net revenue/employee (in thousands)	$118	$173	$368	$178	$400	$309
Book value per share	$0.72	$2.68	$4.29	$25.11	$5.16	$3.44
Price/book value ratio	9.6x	2.5x	4.5x	3.0x	2.9x	3.2x
Growth statistics (over comparable quarter):						
Revenue	(43%) (a)	17%	117%	15%	7%	1%
Research and development	36%	38%	214%	(24%)	2%	(12%)
Sales and marketing	122%	(1%)	81%	29%	4%	(12%)
General and administrative	88%	16%	19%	n/a	0%	(34%)
Net income	(4430%) (a)	258% (d)	(1,028%) (f)	32%	(4708%) (i)	105%

a) Quarterdeck's current quarter reflected a significant decline in sell-through for memory management products.
b) Quarterdeck's trailing twelve month results included non-recurring charges of $11.4 million relating to acquisitions.
c) SCO's trailing 12 months included a $38 million charge for the acquisition of the UNIX business from Novell.
d) SCO's comparable quarter included restructuring charges of $4 million.
e) SoftKey announced it will be changing its name to The Learning Company effective October 1996.
f) SoftKey's current quarter included a $120 million charge relating to the acquisitions of The Learning Company, Minnesota Educational Computing Corporation (MECC), and Compton's New Media.
g) SoftKey's trailing 12 months included charges of $473 million related to acquisitions of The Learning Company, MECC and Compton's New Media.
h) Sterling's trailing 12 months included a $240 million gain from an initial public offering of a subsidiary.
i) Sybase's current quarter included a $49 million charge for elimination of non-core products and restructuring charges.
j) Symantec's current quarter included $7.7 million in acquisition and other non-recurring charges.

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HARDWARE COMPANIES

(in millions)

Income statement	AST 6/29/96	Apple 9/27/96	Compaq 9/30/96	DEC 9/28/96	Dell 7/28/96	Gateway 9/30/96
Most recent quarter						
Net revenue	$554	$2,321	$4,481	$2,912 (e)	$1,690	$1,203
Net income (loss)	(99) (a)	25 (b)	350	(75)	103	61
EPS	(2.21)	0.20	1.25	(0.48)	1.05	0.78
Trailing twelve months						
Net revenue	$2,100	$9,833	$17,388	$14,203	$6,283	$4,728
Net income (loss)	(439)	(816) (c)	933 (d)	(261) (f)	330	221
EPS	(10.05)	(6.59)	3.37	(1.69)	3.34	2.83
Net income (loss) as a % of net revenues	(21%)	(8%)	5%	(2%)	5%	5%
Balance sheet						
Cash	$67	$1,745	$3,191	$2,041	$956	$401
Other current assets	655	2,770	4,805	4,984	1,185	681
Other assets	200	849	1,348	2,613	223	334
	$922	$5,364	$9,344	$9,638	$2,364	$1,417
Liabilities	$825	$3,306	$3,807	$6,151	$1,371	$1,416
Equity	97	2,058	5,537	3,487	812	725
	$922	$5,364	$9,344	$9,638	$2,364	$1,417
Other data						
Closing stock price (Sept. 30, 1996)	$5.00	$22.19	$64.13	$35.63	$50.88	$47.88
Common shares outstanding (in millions)	45	125	279	154	97	78
Market value (in millions)	$225	$2,773	$17,891	$5,486	$4,935	$3,741
Price/revenue ratio	0.1x	0.3x	1.0x	0.4x	0.8x	0.8x
Price/earnings ratio - trailing twelve	n/m	n/m	19.0x	n/m	15.2x	16.9x
Price/earnings ratio - future 4 qtrs.	n/m	n/m	10.7x	12.5x	13.3x	10.5x
Headcount (most recent disclosure)	5,700	13,729	17,055	57,000	9,100	9,000
Net revenue/employee (in thousands)	$368	$716	$1,020	$249	$690	$525
Book value per share	$2.16	$16.46	$19.85	$22.64	$8.37	$9.28
Price/book value ratio	2.3x	1.3x	3.2x	1.6x	6.1x	5.2x
Growth statistics (over comparable quarter):						
Revenue	(16%)	(23%)	25%	(11%) (e)	40%	35%
Research and development	9%	(15%)	62%	0%	14%	n/a
Sales and marketing	34%	(5%)	16%	0%	32%	69%
General and administrative	n/a	n/a	n/a	n/a	n/a	n/a
Net income	(212%) (a)	(58%)	43%	(290%) (e)	59%	48%

a) AST's current quarter included a $13.6 million restructuring charge.
b) Apple's current quarter included a $28 million favorable adjustment to previously recorded restructuring charges.
c) Apple's trailing twelve months reflected an after-tax inventory writedown of $388 million and restructuring charges of $130 million after-tax.
d) Compaq's trailing twelve months included a $241 million, or $0.87 per share, charge for purchased in-process technology in connection with the acquisitions of NetWorth and Thomas-Conrad Corp.
e) DEC's current quarter revenues declined due to implementation of a new sales model and lower service revenues. The stock plunged 23% to its two year low following the earnings release.
f) DEC's trailing twelve months included a $492 million restructuring charge.

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HARDWARE COMPANIES - CONTINUED

(in millions)

	Hewlett Packard 7/31/96	IBM 9/30/96	Intel 9/28/96	Silicon Graphics 9/30/96	Sun 9/29/96
Income statement					
Most recent quarter					
Net revenue	$9,105	$18,062	$5,142	$766	$1,859
Net income (loss)	425	1,280	1,312	(22) (d)	123
EPS	0.40 (a)	2.45	1.48	(0.13)	0.63
Trailing twelve months					
Net revenue	$37,321	$74,724	$18,987	$3,092	$7,468
Net income (loss)	2,616	5,097 (b)	4,114	35 (e)	515
EPS	2.48	9.47	4.65	0.20	4.90
Net income (loss) as a % of net revenues	7%	7%	22%	1%	7%
Balance sheet					
Cash	$3,714	$7,002	$5,820	$292	$664
Other current assets	14,539	32,377	5,395	1,645	2,189
Other assets	9,071	38,617	9,857	1,023	769
	$27,324	$77,996	$21,072	$2,960	$3,622
Liabilities	$14,435	$56,628	$5,561	$1,291	$1,502
Put warrants	0	0	547	0	0
Equity	12,889	21,368	14,964	1,669	2,120
	$27,324	$77,996	$21,072	$2,960	$3,622
Other data					
Closing stock price (Sept. 30, 1996)	$48.75	$124.50	$95.44	$22.00	$62.13
Common shares outstanding (in millions)	1,053	522	885	173	195
Market value (in millions)	$51,334	$64,989	$84,462	$3,806	$12,114
Price/revenue ratio	1.4x	0.9x	4.4x	1.2x	1.6x
Price/earnings ratio - trailing twelve	19.6x	13.1x	20.5x	108.3x	12.7x
Price/earnings ratio - future 4 qtrs.	17.9x	8.2x	14.8x	9.8x	18.1x
Headcount (most recent disclosure)	105,200	302,196	41,600	10,358	17,407
Net revenue/employee (in thousands)	$355	$247	$456	$298	$429
Book value per share	$12.24	$40.93	$16.91	$9.65	$10.87
Price/book value ratio	4.0x	3.0x	5.6x	2.3x	5.7x
Growth statistics (over comparable quarter):					
Revenue	18%	8%	23%	29%	25%
Research and development	21%	8%	34%	49%	29%
Sales and marketing	12%	8%	28%	35%	32%
General and administrative	n/a	n/a	n/a	n/a	n/a
Net income	(26%) (a)	336% (c)	41%	(137%) (d)	46%

a) HP's current quarter included a $0.13 per share charge for the exit from disk-mechanism manufacturing.
b) IBM's trailing 12 months included non-recurring charges of $488 million.
c) IBM's comparable quarter includes a $1.8 billion charge for the write off of purchased technology in the Lotus acquisition. Earnings per share would have been $3.26 higher without the charge.
d) Silicon's current quarter included $10 million in charges for retrofitting of microprocessor boards and $21 million in Cray Research merger related expenses.
e) Silicon's trailing 12 months include a $102 million charge for in-process R&D relating to the Cray Research acquisition.

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Appendix

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of $20 million per year per joint venture or an agreed upon percent of revenues.

- Total funding to date for the Cable JV has been $41 million and for the Interactive JV has been 9 million. MS share of the operating losses of the Cable JV total $13.2 and for the Interactive JV total $8.8 million.

SANTA CRUZ OPERATION, INC.

(Financial information shown below is the most recent available.)

	FY95 Ended Sept 30 '95	FY96 Ended Sept 30 '96	Change $	Change %
Net revenue	$199	$208	$9	5 %
Cost of revenue	53	52	(1)	(2)
Gross profit	146	156	10	7
Controllable expenses	152	178	26	17
Net income	($6)	($22)	($16)	267

- SCO sent Microsoft a letter in which they want "out" of the 1987 "Centaur" Agreement (originally entered into between MS and AT&T). The Centaur agreement requires SCO to make its UNIX/Intel operating systems "binary(backward) compatible" and requires SCO to pay MS a royalty of $15 per copy. SCO claims that there is no longer any legitimate business reason to maintain binary compatibility and therefore, to continue to pay royalties to MS, and that any MS insistence on keeping the Agreement in force is anticompetitive/antitrust violation. LCA is preparing an answer.
- SCO management is under a lot of pressure to fight an unusual high turnover, and is developing special retention programs to lower the turnover rate.
- SCO plans to make a $2 million convertible loan to JBS (Jones Business Systems - a reseller) for the marketing of SCO products.
- Without "non-recurring charges", SCO's net income would have been 1019 and 1319 respectively for FY95 and FY96. The charges in FY96 were due to the acquisition of the Unixware system from Novell.

MFS COMMUNICATIONS COMPANY, INC.

(Financial information shown below is the most recent available.)

	Quarter Ended June 30, 1995	Quarter Ended June 30, 1996	Change $	Change %
Net revenue	$ 140	$ 230*	$ 90	64 %
Cost of revenue	NA	NA	NA	NA
Gross profit	140	230	90	64
Controllable expenses	205	330	125	61
Net income	$ (65)	$ (100)	$ (35)	54

- On August 12, UUNET completed its merger with MFS and became a subsidiary of MFS. Each UUNET share was converted to 1.777776 shares of MFS. Microsoft currently hold 4.1% of MFS worth $330 million at the October 17 closing.
- On August 26, MFS and WorldCom, Inc. announced that they had executed a merger agreement under which each share of MFS will be exchanged for 2.1 shares of WorldCom. Upon closing, expected to occur four to eight months after signing, Microsoft will hold 15.5million shares of MFS/WorldCom, or 2.2%, worth $336 million at the October 17th WorldCom share price.
- MS' Network Agreement with UUNET, which is expected to continue in the foreseeable future, is being renegotiated to provide for more favorable terms.

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MICROUNITY SYSTEMS ENGINEERING, INC.

(Financial statements not meaningful)

- Facing severe financial problems, MicroUnity was planning for an IPO in September, but none of the investment banks they met with agreed to help them. They stated that MU was in too many businesses, it was confusing, that they were still a "concept" IPO and that they had too large a cash burn rate.
- MU finally closed its fab on July 2, sold it to Interconnect for $11 million in cash and the assumption of the $17 million lease.
- MU laid off all but 30 people, and will continue to function as a "core technology" company.

INDIVIDUAL, INC.

(Financial information shown below is the most recent available)

	June 30, 1995	June 30, 1996	Change $	Change %
Net revenue	$4.1	$5.6	$1.5	37 %
Cost of revenue	1.8	2.6	0.8	44
Gross profit	2.3	3.0	0.7	30
Controllable expenses	3.7	5.8	2.1	57
Net income	($1.4)	($2.8)	($1.4)	100

- On July 24th, Chairman and CEO Yosi Amram took a leave of absence and then resigned as CEO on August 7th after the board lost confidence in his ability to direct the activities of the company. He has been replaced by Michael Kolowich, former President of AT&T New Media Services and founder of Ziff-Davis Interactive. Amram remains a member of the board.
- As of Oct. 17, Individual's share price has fallen to $6.25 from the March 15 IPO of $14., MS' $10.5 million investment is worth $6.6 million.
- Revenues and expenses for the quarter were in line with expectations, although total subscribers jumped sharply from 138,000 to 280,000.

LIGHTSPAN PARTNERSHIP, INC.

(Financial information shown below is the most recent available)

	Actual YTD June 30, 1996	Plan YTD June 30, 1996	Change $	Change %
Net revenue	$4.4	$0.9	$3.4	370 %
Cost of revenue	2.8	0.7	2.1	285
Gross profit	1.6	0.2	1.4	659
Controllable expenses	14.0	14.5	(0.5)	(3)
Net income	($12.4)	($14.3)	$1.9	NM

- On September 20, 1996, Lightspan raised an additional $20 million in financing. During this round, MS invested an additional $1.8 million for 297,619 Series C Preferred stock at $6 per share. This, in addition to Microsoft's previously invested $10.1mm for 3,333,333 Series B Preferred Stock at $3 per share gives Microsoft approximately an 11% stake in the company.
- Lightspan Partnership's now has 291 employees on payroll and its mission is to become a major player in the field of interactive multimedia "edutainment" and curricular software targeting the K-6 education market. Initially, the company's design focus was TV/NTSC but now is also focusing on porting the software to the Windows, Macintosh, and PlayStation platforms. At present, Lightspan has products on both the Windows and Macintosh

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platforms. Furthermore. The Lightspan Network, the company's Internet product. was successfully launched in mid-January.

OTHER INVESTMENTS (LESS THAN $10 MILLION)

HELICON PUBLISHING LIMITED

- Helicon introduced a downwardly revised budget for the fiscal year ending March 1997. Revenues missed expectations by 20% for the five months ended August due to disappointing sales of its Hutchinson Multimedia Encyclopedia to the electronic retail trade who are waiting for the 1997 edition and due to late publishing on some CD ROM titles. The company. however, managed to make a profit of US$50,000.
- Helicon secured a loan facility of US$450,000 with a bank and continues to seek a partner willing to invest US$465,000.

ACADEMIC SYSTEMS CORPORATION

- Academic Systems completed its Series E Preferred round of financing for $10 million. of which MS committed an additional $1 million for 333,333 shares; Microsoft now owns 1,801,426 Preferred shares for a 8.0% stake in the company.
- Academic Systems has adopted a new method of revenue recognition in accordance with Generally Accepted Accounting Principles. resulting in an increase in the portion of fees recorded as deferred revenues. Before this adjustment, however, revenues missed expectations for the year ended June by 32% due to slower than expected adoption of the company's products on new campuses.
- Academic Systems has installed its products on 34 campuses, as of October 15, 1996. The company has recently signed a multi-campus, system-wide license agreement with the New York City University system, the third largest university system in the United States.

METRICOM, INCORPORATED

- On August 29, 1996 Metricom completed a $45 million private placement of its convertible preferred. Losses sustained to date are primarily attributable to the continued deployment costs of the "Ricochet" network and infrastructure costs necessary to scale the organization. These losses translated to $0.43 per share and $0.63 per share in the June quarters ended 1995 and 1996, respectively.

DREAMWORKS AND DREAMWORKS INTERACTIVE

- DWI will ship its first five titles this fall. Cyberchef, Chalktalk and Goosebumps, Escape from Horrorland will ship on September 18th and Movie Maker and Neverhood will ship on October 18th. These properties were debuted at the E3 conference in Los Angeles from May 16th to 18th. A distribution agreement with Microsoft is close to completion under which MS will receive 14% of wholesale revenues for distributing DWI titles.
- To date, MS has contributed $11.45 million to DWI and will have contributed $15.8 million in by the end of Q97-1. DWI now employs 72 people (compared to 65 last quarter)

CITRIX SYSTEMS, INC.

- Net revenues for the 2nd quarter were $9.5 million, up 287% from the prior year and up 22% from the preceding quarter. Growth continued to accelerate driven by demand for the Win NT-based product, WinFrame. During the quarter, MS and Citrix signed an agreement to distribute Citrix's ICA protocol in future versions of WIN 95, Win NT and IE.

MONOTYPE TYPOGRAPHY LIMITED

- Revenues for the September quarter were up 3% from the previous quarter to $2.3 million. Profits were up 13% reflecting the favorable shift towards higher margin OEM revenues. In November 1995, MS restructured its $3 million investment. The restructuring provides for long-term maintenance of the font library by Monotype in return for a gradual increase in Monotype's ownership.

ASCII NETWORK TECHNOLOGY, INC.

- Revenues for the June quarter were ¥308 million up 50% from last year's ¥153 million. Losses narrowed to ¥29 million from ¥56 million last year.
- It is expected that the e Company will reach break-even in the September quarter.

VANSTAR CORPORATION

(Financial information shown below is the most recent available.)

	Year Ended Apr 30 1995	Year Ended Apr 30 1996	Change $	Change %
Net revenue	$1,385	$1,805	$420	30 %
Cost of revenue	1174	1560	386	33
Gross profit	211	245	34	16
Controllable expenses	210	228	18	9
Net income	$1	$17	$16	1,600

- On May 18, 1995 MS and Vanstar signed a BackOffice Development Agreement. which requires MS to provide Vanstar up to $16 million in marketing development funds over two years. Vanstar will build a nationally deployed systems integration and services business tied to MS's BackOffice product suite, and will hire 400 system engineers by May 1997. MS will recoup the funds through a royalty on revenues generated by Vanstar's system integration business. Vanstar also issued MS warrants to purchase Vanstar common stock.
- On March 11, 1996 Vanstar completed an IPO of 8 million shares at $10 per share. Vanstar is presently trading at $28. Microsoft's 1.56 million shares are worth $44 million.
- As of September 1, 1996, Vanstar had hired 203 systems engineers, and 134 had achieved MCSE status.

THE MICROSOFT FAMILY OF FUNDS

During Q95-4, Microsoft's cash investment portfolio was migrated into five distinct sub-portfolios - four fixed-income portfolios and one opportunity portfolio. Each portfolio is a separate mutual fund or risk bucket, with unique guidelines and risk/return expectations. Collectively, the portfolios are the Microsoft "Family of Funds".

With this strategy, MS is increasing the sophistication of our portfolio management efforts, focusing on Total Rate-of-Return portfolio management (as opposed to yield-to-maturity) and using duration as a risk management tool (instead of term-to-maturity).

The goals of this strategy are to:

- Segregate the cash portfolio into individual funds of a more manageable size.
- Enhance the total return on Microsoft's Cash assets.
- Establish risk and return expectations for each Fund.
- Provide pro-active risk management of financial assets.
- Benchmark performance relative to market indices.
- Allow allocation of cash among the various risk segments of the short-term fixed-income market.

Following is a high level summary of the general guidelines of each Fund:

- **Level 1:** Money Market Fund–Designed to meet the operating cash requirements of MS Corporation, and other legal entities, MS MBV, MB IBV, and MS Puerto Rico, this fund has a targeted duration of 20-45 days and a maximum maturity of 91 days. Little principal value fluctuation is expected. Benchmark: 30-Day US Treasury Bill.
- **Level 2:** Enhanced Money Market Fund–Designed as a secondary source of liquidity supporting the Money Market Fund, this fund has a maximum maturity of 13 months. The longer targeted duration of 2-6 months, will provide opportunity for increased return with a modest increase in risk. A small amount of principal value fluctuation is expected. Benchmark: 90-Day US Treasury Bill.
- **Level 3:** Short-term Fixed Income Fund–This fund will carry an increased focus on interest rate

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INVESTMENTS

WANG LABORATORIES, INC.

(Financial information shown below is the most recent available.)

	Fiscal Year Ended Jun. 30, 1995	Fiscal Year Ended Jun. 30, 1996	Change $	Change %
Net revenue	$947	$1,090	$143	15%
Operating expenses	1,014	1,087	73	7%
Operating income (loss)	(67)	3	70	NM
Other income (expenses)	6	(4)	(10)	NM
Net income	($61)	($1)	$80	NM

- Wang continues to expand as a service provider and a developer of open systems software for NT. A smaller portion of revenues now comes from support for its terminated proprietary products. For the fiscal year ended June 30, 1996, net revenue increased 15% with service revenue increasing 24% and product sales growing 1%. EBITDA increased 65% from $83 million to $138 million.
- On July 24, Wang announced it had signed an agreement to acquire I-NET, a provider of outsourced network and desktop management services, for $167 million. It is hoped that this combination will enable Wang/I-NET to become a premier provider of seamless IT outsourcing services from the desktop through local and wide-area networks to the Internet. I-NET is expected to add over $300 million in revenue to Wang in fiscal year 1997.
- Last year, MS signed a broad technical, service, marketing, patent, and investment agreement with Wang. Under the agreement, Wang's desktop imaging and object controls are incorporated in certain MS products. Additionally, the two companies are working together on the definition of work management APIs. Wang's structured workflow technology manages the routing and delivery of this data and documents. MS also designated Wang as its "preferred" vendor of imaging and workflow software and is engaging in co-marketing. The agreement also expands Wang's role in providing outsourced support services for MS products.
- MS also purchased $90 million face amount of 4.5% convertible preferred stock due in 2003 for $84 million. The stock is convertible into Wang common at $23 per share and represents about 10% of Wang's common stock on a fully diluted basis. Wang's common was recently trading at about $18 per share, up from $13 per share at the time the deal was signed, but down from a high of $24.

MOBILE TELECOMMUNICATIONS TECHNOLOGIES CORPORATION (MTEL)

(Financial information shown below is the most recent available.)

	Six Months Ended Jun. 30, 1995	Six Months Ended Jun. 30, 1996	Change $	Change %
Net revenue	$107	$169	$62	58 %
Operating expenses	101	169	68	67
EBITDA	6	(0)	(6)	(104)
Other expenses	(15)	(62)	(48)	323
Net income	($9)	($63)	$42	580

- Mtel is the leading provider of nationwide and alpha-numeric paging services under the SkyTel brand. Mtel is also developing SkyTel 2-Way, which has caused a dramatic increase in operating expenses.

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- Mtel recorded a year-over-year increase in net pager units in service of 57.5% to 1.29 million units. However, net units increased by only 53 thousand in the 2nd quarter due in part to a strategy of reducing units sold through lower margin and higher churn distribution channels. Quarterly operating cash flow from operations turned positive to $4.4 million from negative $8.8 million in the prior quarter in part due to improved cost control.
- Skytel's one-way revenue was $79.0 million, an increase of $26.8 million or 51% over the prior year. Quarterly operating cash flow from one-way operations increased to $28.7 million, an OCF margin of 36.7%.
- The two-way business achieved several important milestones including a very favorable technical analysis by Lockheed Consulting, but units ended the quarter at only 24 thousand.
- John T. Stupka, formerly CEO of SBC's wireless business, joined Mtel as President and CEO. John Palmer remains Chairman.
- During the quarter, Mtel also completed several important financial transactions, including the sale of its stake in Mercury Paging, the sale of additional preferred stock and a consent solicitation to allow additional borrowing capacity under its bond indenture.

STAC, INC.

(Financial information shown below is the most recent available.)

	Nine Months Ended Jun. 30, 1995	Nine Months Ended Jun. 30, 1996	Change $	Change %
Net revenue	$34.5	$34.5	$0.0	0 %
Cost of revenue	4.0	4.8	0.8	20
Gross profit	30.5	29.7	(0.8)	(3)
Controllable expenses	33.0	34.0	1.0	3
Net income	($2.5)	($4.3)	($1.8)	NM

- June 1994, MS and Stac signed cross-license and investment agreements to end a disk compression patent dispute. MS agreed to pay Stac license royalties of $1 million per month for 43 months. MS also purchased $40 million of 4.0% convertible preferred stock, which was converted to common equity on November 9, 1995.
- Revenues were flat versus the year-ago period. Software sales declined 22% while hardware revenues increased 85%.
- Controllable expenses in the current nine month period include $12.2 million of purchased R&D.

Before this charge, net income would have been $8.3 million and EPS would have been $0.27.

- At a price of $7-7/8, MS's 4,458,746 shares of Stac common stock have a market value of $35 million.
- On September 9, Stac announced the formation of a new subsidiary, Hi/fn, which includes the hardware business and will focus on the OEM networking products market. Stac plans to spin-off this subsidiary.

MSNBC

(Financial statements not meaningful)

- The MSNBC 24 Hour Cable News joint venture and the interactive online news joint venture were both launched on Monday, July 15. The Cable JV was launched with approximately 21 million subscribers, including recent agreements with Cox, Adelphia, Time Warner's Philadelphia region and other small MSOs to distribute the MSNBC channel.

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- The joint ventures call for a Microsoft investment of $220 million for MSNBC Cable and $2.5 million for the online services, both paid over five years. All profits or losses from the joint ventures are distributed or funded 50/50 by MS and NBC.
- The joint ventures will pay NBC a licensing fee of approximately $26 million per year per joint venture for the first 5 years for the use of NBC assets. The licensing fees after 5 years is the greater

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